

**CENTRAL BANKING
UNDER THE
FEDERAL RESERVE SYSTEM**



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CENTRAL BANKING UNDER THE FEDERAL RESERVE SYSTEM

**WITH SPECIAL CONSIDERATION OF THE
FEDERAL RESERVE BANK OF NEW YORK**

**BY
LAWRENCE E. CLARK, PH. D.**

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TO
MY FATHER AND MOTHER

PREFACE

In this book I have sought to provide an account of the development of the Federal Reserve system during the twenty years of its existence, laying particular stress upon its operation in the capacity of a central banking institution. The development of the system presents certain features which are common to all the Federal Reserve banks. In order to gain a clearer understanding, however, of the operation of central banking under the system, I have given more detailed consideration to the Federal Reserve Bank of New York because of the relative importance of its size and power and the special significance which its policies and operations have held for the people of the whole United States. There are pointed out the relationships between that Bank and the other Reserve banks and the Federal Reserve Board, the failures and the achievements of the Federal Reserve system, and conditions which have been different from those intended in the Federal Reserve Act. The prime purpose of a central banking institution is *public service*. I endeavored, therefore, in the analytical phases of this book, to judge from the point of view of the general welfare.

The research work was carried on for the most part in the library of Columbia University, the financial library of the Federal Reserve Bank of New York, and in the economics division of the New York Public Library. Government publications, including the annual reports of the Federal Reserve Board, the Federal Reserve Bulletins, and the hearings before the Banking and Currency Committees of the United States Congress, and the publications of the Federal Reserve banks constituted an underlying source of information. This material was supplemented by reference to specialized works and correspondence with officials of the Federal Reserve system.

I wish to make special acknowledgment to Professor

H. Parker Willis of Columbia University for valuable information and for his helpful criticism. Thanks are due to Professors Benjamin H. Beckhart, James W. Angell, and John Maurice Clark of Columbia University for their considerate reading of the book. It is, perhaps, unnecessary to state that the author alone is responsible for the conclusions expressed herein.

Finally, I desire to express my deep appreciation of the aid of my wife, Gladys Rice Clark, who rendered much interested and efficient assistance at various stages during the progress of the work.

LAWRENCE E. CLARK

NEW YORK CITY,
November, 1934.

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**CENTRAL BANKING
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CHAPTER I

THE NATIONAL BANKING SYSTEM

American Banking Development

Previous to the establishment of the Federal Reserve system in 1914 there developed in the United States a banking structure quite different from that of other countries. There were forty-eight state governments, each one of which had jurisdiction over its chartered banks. There was also a group of national banks in each state under the jurisdiction of the United States Government, forming what was known as the national banking system. A dual banking network thus existed embracing state banks on the one hand and national banks on the other. Altogether the number of commercial banks in these political jurisdictions totaled over 25,000, in 1913, and there was no organic connection between them.

The existence of these independent local unit banks was largely due to the influence of the frontier life on the American people. The broad geographical expanse with its frontier conditions made for individual initiative and self-reliance in economic and political affairs. As the settlement of the large public domain proceeded westward and banks were established to serve the needs of the people, this spirit of independence manifested itself in the banking structure of the nation and decentralization became the accepted policy. The unpopularity of the First Bank of the United States was followed in due course by hatred of the Second Bank of the United States and the refusal to recharter it in 1836. The people had become suspicious of and antagonistic toward any centralized banking institution or suggestion of monopoly of credit.

Consequently banks were set up in each state independent of the Federal Government and unconnected with banks in

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any other state.¹ An extremely uncoordinated situation developed in the nation's banking structure. Lacking a "banking tradition" enforced by public opinion, as in England or Scotland, banks became either practically a law unto themselves or were subject to weak legislation and control. Unscrupulous individuals in the West and South inflicted upon those pioneer communities the same faulty money and banking practices from which the people of the Atlantic seaboard states had suffered in colonial times and our early national life, and which they had thrown off in considerable measure after much sad experience. The kind of banking which was carried on in this period prior to the Civil War was dubbed wildcat banking, being characterized by deception, exploitation, uncertainty, and insecurity, and the money put out was called wildcat currency. A multitude of different kinds of money was in use. It circulated at various rates of discount, some of it being worthless and nearly all of doubtful value.

Owing to the financial exigencies of the Civil War, Congress passed on February 25, 1863, the National Bank Act which was subjected to revision, and on June 3, 1864, a substantially new law was enacted.² The National Bank Act provided for the chartering of national banks by the Federal Government in any part of the Union and the issue of bank notes of uniform value. It sought to aid the financing of the Civil War by the sale to these banks of government bonds bearing the circulation privilege as security for the national bank notes. The Act resulted in the establishment of a system of banks on a national scale, incorporated by the same governmental authority, subject to the same laws and regulatory control. The national banking system was characterized by free banking, independent local unit banks instead of large banks with branches, and fixed reserve requirements.

The wildcat currency problem was solved by an Act of

¹ See W. G. Sumner, *History of Banking in the United States*; John Jay Knox, *A History of Banking in the United States*; Charles A. Conant, *A History of Modern Banks of Issue*, Sixth Edition, chapter XIV.

² See Knox, *op. cit.*, chapters XIV and XV; Conant, *op. cit.*, chapter XV.

Congress, March 3, 1865, providing for a tax of 10 per cent on the amount of the notes of state banking associations. This tax made the issue of such notes unprofitable and effectively put them out of circulation. As compared with the present time relatively little deposit banking was done prior to and during the Civil War period, the banks relying upon the privilege of issuing notes for support. So when the issue of state bank notes was suppressed by the federal tax it was hoped that the state banks would liquidate and take out national charters. In fact it was stated in Congress at the time the bank note tax measure was introduced that the intention was to have national banks exclusively, a unified banking system. Many state institutions did take out national charters and others liquidated voluntarily or failed. Consequently their number dwindled while, on the other hand, national banks multiplied.

The results of taxing the notes issued by state banks were working out as anticipated when the use of bank checks in business in place of bank notes began to assume major proportions. This practice resulted in the rise of deposit banking. As a consequence, about 1880, banking under a state charter took a new lease on life. It again became profitable to operate state banks and they rapidly increased in number during the last quarter of the century. There has continued to exist, therefore, this dual banking structure with its competition between the National Government on the one hand and the several state governments on the other for incorporating banks.

The National Bank Act, setting as it did at the time relatively high standards, caused national banks to be considered favorably by the people and served as a model for the enactment of new banking laws in various states in the following years. Among the advantages of the Act probably the chief were that it provided the country with bank note money of uniform value and furnished the Government with a market for its bonds. Although the advantages of the national banking system over the chaotic conditions which had prevailed prior to the Civil War were much appreciated by

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the people, very early in the history of the system some deficiencies appeared. These were, however, not generally felt until the '80s. Aggravated by the depression of 1893 the deficiencies became more pronounced and with their periodical recurrence in succeeding years they assumed major importance.

The defects of American banking under the national banking system as they finally developed may be classified under the following subjects: scattered and pyramided reserves, concentration of reserves in New York, use of reserves in stock speculation, recurrent financial panics, currency, clearing and collection, discount market and domestic exchange, foreign exchange and foreign trade financing, treasury operations, and credit control.

Scattered and Pyramided Reserves

Under the National Bank Act national banks were divided into three classes, those in (1) central reserve cities, (2) reserve cities, and (3) other towns. National banks were required to keep a legal minimum reserve against their deposits and the amount of this required reserve which any bank had to maintain was determined by this classification. The requirements were as follows: National banks in the central reserve cities, New York, Chicago, and St. Louis, had to keep a reserve of 25 per cent in their own vaults. In reserve cities (about sixty of the larger cities) the minimum was also 25 per cent but one-half of it could be kept with national banks in central reserve cities. For banks in other places (usually referred to as country banks) the minimum was 15 per cent, three-fifths of which could be kept with national banks in either central reserve or reserve cities.³

Some states followed the National Bank Act in its classification upon which they based a similar sliding scale of legal reserve requirements and generally permitted their institu-

³ The reserve percentage required of the New York City banks was not far from the reserves actually held by these banks before the National Bank Act was passed. For a discussion of the fixing of these reserve requirements in the National Bank Act, see M. G. Myers, *The New York Money Market*, Vol. I, chapter XI.

tions to carry a larger proportion of the required reserves in other banks. There developed extensive inter-bank balances forming the basis of the correspondent banking system which attained substantial proportions by the first decade of this century. Banks in the smaller cities seized upon the opportunity to keep part of their reserves in the reserve and central reserve cities. The reserve city banks in turn divided their reserves between their own vaults and the banks in New York, Chicago, and St. Louis. Thus the legal reserves of the nation's banking organization were scattered among the thousands of independent unit banks, both national and state.⁴

The reserve arrangement of the national banking system had certain inherent defects and worked badly. It resulted in the pyramiding of reserves. Country banks, upon sending checks to their reserve agents for collection, would count them as legal reserve as soon as mailed. Reserve city banks, upon sending the same checks to their reserve agents in the central reserve cities, would likewise count them as legal reserve as soon as mailed, and therefore before they were collected. Thus some checks were counted twice as reserve or even more times on account of circuitous routing. This practice rendered a substantial amount of the legal reserves fictitious in that they were not cash reserves but paper reserves. For example, the national banks held, on October 2, 1913, \$926,000,000 in cash and paper reserves of \$792,000,000 as against total deposits subject to reserve requirements of \$7,172,000,000. Thus their cash reserves were about 12.8 per cent of their deposit liabilities.⁵ Although possessed of these defects, such a system was very profitable for the country and reserve city banks. Under this system that part of their reserves kept elsewhere could be deposit credit instead of the lawful money which they had to keep in their own vaults, and a certain amount of checks could be counted twice as legal reserve. They therefore were enabled to carry a larger amount of deposit liabilities and make more loans.

⁴ See below, p. 13.

⁵ Conway and Patterson, *The Operation of the New Bank Act*, p. 206.

Concentration of Reserves in New York

The reserves of banks generally over the United States became deposit balances in other banks. Not only was the full amount of the bank balance permitted to be counted as legal reserve deposited but country and reserve city banks deposited in their correspondent banks from 50 to 100 per cent excess reserves.⁶ The reserves of the country banks in the reserve city banks were redeposited by the latter in the central reserve city banks. Bank reserves tended to concentrate, therefore, in the central reserve cities.⁷ By far the greatest concentration was in New York City. Furthermore, banks in the central reserve cities of St. Louis and Chicago kept balances in the New York banks. New York City was the great magnet which attracted bank reserves from all over the country—from cities large and small.⁸ During seasonal and cyclical disturbances as well as in more settled periods bank deposits there were relatively preponderant. National banks in New York City held approximately one-third of the total inter-bank deposits of national banks and about seventenths of the total of the central reserve city national banks.⁹

The dominance of New York City at the time of the organization of the Federal Reserve system is shown also by the following:¹⁰ The amount on deposit from all banks

⁶ L. L. Watkins, *Bankers Balances*, p. 359; Hearings before the Committee on Banking and Currency of the Senate, on H. R. 7837 (S. 2639), 63rd Congress, 1st Session, 1913, Vol. I, p. 825. (Hereafter cited as Senate Hearings on the Federal Reserve Act, 1913.)

⁷ Central reserve city banks numbered less than 1 per cent (after 1908) of national banks but held about one-half the inter-bank deposits of national banks. For detailed statistics regarding inter-bank deposits prior to the Federal Reserve system see tables in Watkins, *Bankers Balances*, chapter II.

⁸ Hearings before a Subcommittee of the Committee on Banking and Currency of the House of Representatives, on H. R. 429 and 504, 62nd Congress, 1st Session, 1912, Exhibit 133, pp. 1192-1212, 1654-1660, 1981. (Hereafter cited as Hearings in the Money Trust Investigation, 1912.)

⁹ Watkins, *op. cit.*, p. 20.

It will be recalled that in 1913 there were over 25,000 banks in the country. Out of 111 banks and trust companies in New York City, 30 had 19,015 bank deposit accounts of out-of-town banks. And 10 banks out of the 30 had 15,483 bank deposit accounts. These 10 New York banks had 60 per cent of all deposits of all the state and national banks of the country. Senate Hearings on the Federal Reserve Act, 1913, Vol. I, pp. 819 and 823.

¹⁰ Decision of the Reserve Bank Organization Committee, Table D, p. 14.

and trust companies throughout the United States, February 14, 1914, in the national banks in New York City was \$742,386,939. The next nearest city was Chicago with deposits of \$278,824,567. Indicative of the extent to which reserves were concentrated in New York is the following: The reserve in the vaults of national banks in New York City, consisting of specie and legal tender notes, on January 13, 1914, was \$313,586,128. Chicago was second with reserves of only \$88,732,480. Further evidence of the predominance of New York City as a financial center is indicated by the following figures ¹¹ of national banks as of March 4, 1914.

	New York	Chicago
Capital and surplus	\$ 248,505,000	\$ 69,050,000
Individual deposits	771,724,999	211,558,247
Loans and Discounts	1,082,272,650	335,820,233

All reporting banks ¹²—National, State, Savings and Loan, and Trust Companies as of June 4, 1913.

	New York	Chicago
Capital and surplus	\$ 563,221,701	\$151,882,559
Individual deposits	2,866,351,069	682,498,992
Loans and Discounts	2,306,503,682	690,799,087

The reasons for the preponderant concentration of bank resources in New York City were several. It was necessary to allow outside banks to keep reserves there in order to facilitate the financing of domestic and foreign exchange operations, as had been customary before the establishment of the national banking system. The banks sold exchange on New York to their customers on which they realized a profit. Also in normal times the banks kept as little as possible of primary reserves preferring to put the rest to work in other banks drawing interest. The bank balances in New York City ordinarily served as a convenient secondary reserve in that they could be withdrawn promptly by the other banks when needed in their own communities. They, therefore, looked upon bank balances in New York as a good way to "invest" part of their resources even though they could, at times, have loaned all their funds at home, since such a

¹¹ Ibid., Table E, p. 15.

¹² Ibid., Table F, p. 16.

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plan constituted a diversification of their assets. These balances secured for them about 2 per cent interest and at the same time they were usually liquid, being available to them on call.

Another factor was that they wanted an established banking connection to serve as a source of borrowing. It gave the banks a feeling of security that they would be "taken care of" in times of seasonal or cyclical stringency or emergencies of one kind or another. Furthermore, the New York banks served the outside banks as collection agencies. They collected cash and non-cash items payable in various parts of the country for their correspondent banks which service was highly valued by the latter. With all of the above motives for keeping deposits in the New York banks, such deposits would at the same time count as reserve under the National Bank Act and the laws of the various states. Thus while all these advantages would be accruing to the outside banks they would be satisfying their legal reserve requirements in part with the very same bank deposits which superinduced these advantages and on top of all that were enabled to make more loans in their own localities.

Use of Reserves in Stock Speculation

In spite of the apparent advantages which the outside banks gained by sending their reserves and surplus funds to New York, the New York banks would have been unwilling to accept them for deposit if they could not have found a place to invest them. The reason for this was that the New York City banks, like all the others, were governed by the profit motive and therefore maintained their cash reserves close to the legal minimum. Though they held to a very large extent the ultimate bank reserves of the country they did not assume central banking responsibility with regard to them. To have had available excess reserves for a time of credit stringency, they would have had to carry idle reserves at other times, and this was incompatible with the competitive, profit-seeking economy which motivated their loan and investment policies.

Opportunity in New York City was afforded the banks to

make a profit on the bank balances by loaning them in the call loan market. In New York City a securities market of national proportions was centered. This market was financed in large measure by call loans supplied by the banks under a daily settlement system. More money could be loaned on call in New York at a higher rate than elsewhere. This was the chief outlet for bankers' balances in New York. And so profitable was this outlet that not only were the New York banks eager to have the deposits of outside banks but competition for them became so keen that they were willing to offer 2 per cent interest to obtain them.

The outlying banks thus secured deposit balances in the New York banks payable on demand and the latter converted these balances into call loans secured by stock exchange collateral.¹³ Furthermore, the concentration of funds in New York City was augmented by the practice of the banks in sending funds to their New York correspondents not for keeping to their credit but to be loaned directly for the stock market.¹⁴ The dominance of the New York City banks in the field of stock exchange loans at the time of the organization of the Federal Reserve system is evident from the following facts: ¹⁵ The total amount of bought paper and stock exchange loans made by national banks in New York City to non-customers throughout the United States, January 13, 1914, was \$263,803,618. The next nearest city was Boston, the figure for which on the same date was \$47,402,893.

Recurrent Financial Panics

The ill effects of padding reserves and the concentration of funds in New York, apparent in normal times, became severe in times of pressure. The concentration of funds in New York involved a seasonal movement of money between New York and the interior. For example, in the fall and winter funds flowed to New York and then in the spring and

¹³ Hearings in the Money Trust Investigation, 1912, pp. 952-963, 1192-1212.

¹⁴ Report on the Money Trust Investigation, 62nd Congress, 3rd Session, House Report No. 1593, p. 159; Senate Hearings on the Federal Reserve Act, Vol. I, pp. 510 and 825.

¹⁵ Decision of the Reserve Bank Organization Committee, Table D, p. 14.

summer when the agricultural communities needed cash for planting and harvesting the interior banks recalled funds. This seasonal movement of money was not only economically wasteful but resulted in wide interest rate fluctuations.¹⁶

The most serious phase of this concentration of funds in New York was their use in the call loan market which resulted in a tendency to inflate stock prices. At times nearly all the bank reserves of the nation were put to the service of the stock market speculators. During the period of a plethora of funds in New York, the banks' loans to brokers "boosted" stock prices. Normally when outside banks requested their deposits, the New York banks called their loans to brokers and sent them the funds. But as stock prices rose their maintenance became ever more difficult and the New York banks were increasingly reluctant to part with funds which belonged to others. A substantial decline in the reserves of the New York Clearing House banks warned of approaching disaster.

At times when the credit situation was more or less stringent the calling of loans had an unbalancing influence in the money market and on stock exchange transactions the effect of which was felt throughout the nation.¹⁷ Outlying banks which had secured a banking connection in New York City in order to be able to borrow from it in an emergency not only found they could not borrow but could not get returned to them the very reserves which they had previously sent to New York and which were supposed to be payable on demand. There was no central bank which

¹⁶ See E. W. Kemmerer, *Seasonal Variations in the Relative Demand for Money and Capital in the United States*, Senate Document 588, 61st Congress, 2nd Session, published by the National Monetary Commission.

¹⁷ Mr. Sol Wexler, a New Orleans banker, said, "the first radical reduction in reserves exhibited itself in the New York bank statement, and that attracted the attention of the whole country to the condition in New York. The moment we all saw that condition, we had to draw our money out of New York in order to intrench ourselves, and in doing so we further weakened New York, so that we contributed in a sense to the acute condition that existed in New York. Our country bank correspondents, when they found that we were drawing our money out of New York with a view of strengthening ourselves, turned around and drew it out of us to strengthen themselves. So that the whole system broke down because of its inefficiency." Senate Hearings on the Federal Reserve Act, 1913, Vol. I, p. 95.

could regulate the money market and serve as a lender of last resort for the New York banks as a whole. The outside banks, not obtaining their New York balances, could not finance the agricultural and business requirements of their customers nor meet the claims of their depositors. Just at crucial times when bank credit, in accordance with the central banking rule, should have been enlarged at increasingly high rates to deserving applicants it was practically unobtainable at any price for anyone.¹⁸ Recurrently such financial panics made their appearance, characterized by non-redeemability of bank deposits, extremely high interest rates, runs on banks and the refusal of credit to deserving firms. A typical experience was that of the Boston banks which, when the panic of 1907 occurred, had on deposit in New York banks subject to check from \$25,000,000 to \$30,000,000. When the Boston banks needed it and requested it "they could not get a cent of it." "The New York banks said, 'We have got your money and we are going to use it' and they did."¹⁹

Paradoxical as it is, the fact is that one of the reasons why the outside banks wished to keep deposits in New York City was that it gave them a feeling of security and that they would be "taken care of" in time of need. And yet when the time of greatest need came they could not be "taken care of." The correspondent banking system with its concentration of bank reserves in New York City, resulting in their feeding of stock speculation, made the commercial banking system of the country dependent for its "liquidity" upon the condition of the stock market—a situation not consonant with commercial banking principles. In the absence of any centralization of reserves confined to commercial banking purposes it was a case of making the best of a bad situation

¹⁸ For a comprehensive survey of the operation of the national banking system during crises, see O. M. W. Sprague, *History of Crises under the National Banking System*, Senate Document 538, 61st Congress, 2nd Session, published by the National Monetary Commission.

¹⁹ Testimony of William A. Gaston, President of the National Shawmut Bank, Boston, Mass., before the Reserve Bank Organization Committee at Boston, January 9, 1914: contained in the *Stenographic Minutes of the Hearings before the Reserve Bank Organization Committee*.

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and hoping for the best to come. And when the whole banking structure broke down, in frantic efforts to relieve the situation, in New York and some other cities, a form of bank coöperation was resorted to through their clearing house associations which involved the pooling of reserves and the use of clearing house certificates.²⁰ But these organizations were primarily local in their efforts, were quite ineffectual so far as general credit conditions were concerned, and were disbanded in due course after each stringency.

Currency

The currency in use was inelastic. Most of the discussion regarding inelasticity of the currency during the period of banking reform agitation was directed against the inelasticity of bank notes. But there was deposit currency, circulating by means of checks, which was also inelastic. By inelasticity is meant not that the currency could not be increased in amount but that it could not be expanded and contracted in accordance with the increase or decrease in the demand for it.

There were in circulation in 1913 the following kinds of paper money: gold certificates, silver certificates, United States notes, Treasury notes of 1890,²¹ and national bank notes. Of all the kinds of money in circulation the national bank notes were the only ones which could be increased without increasing the amount of monetary metal in the hands of the Government. They were the only ones offering any possibility of expansion along with expansion in business. These notes were extremely inelastic, however, in that their volume depended upon the amount available and the price of United States Government bonds, against which they were issued.

The amount of government bonds available for security against the bank notes was limited by their use in protecting public deposits and as an investment medium. Moreover,

²⁰ See footnote 24 regarding clearing house certificates and the pooling of reserves.

²¹ The Treasury had announced a policy of retiring the Treasury notes of 1890 as rapidly as they were turned in and relatively few were in circulation.

the banks were limited in the amount they could issue by their capitalization. And even though the notes could be obtained further inelasticity was present on account of the delay involved in making them available. They not only did not expand with the volume of trade but once issued their contraction was very difficult. As a matter of fact the volume of national bank notes commonly decreased when business expanded.²²

The deposit currency, which comprised a much greater proportion of the medium of exchange than paper currency, was inelastic because of the scattered reserves independently controlled and the fixed percentage of reserve required by law. There was no general organized pooling of reserves from which particular banks could be served in time of stringency. When these banks were "loaned up" they were unable to relieve the credit strain in their communities.²³ This inelasticity of both deposit and paper currency accentuated seasonal fluctuation in interest rates and widened the amplitude of the business cycle.²⁴

²² Report of Indianapolis Monetary Commission, 1898, pp. 224, 227, 231, 309; Report of National Monetary Commission, Jan. 9, 1912, Senate Document 243, 62nd Congress, 2nd Session.

²³ See above discussion concerning the use of reserves in stock speculation and recurrent financial panics.

²⁴ In the larger cities the members of the clearing house associations sought temporary relief from the inelastic currency and stringency through the issuance of certificates by the clearing houses. The first issue of these certificates was by the New York Clearing House in 1860 and they were issued in New York and other cities in every decade until the establishment of the Federal Reserve system. Probably the first time that the New York banks cooperated for the protection of their reserves in an emergency was not in 1860 but in 1814. Regarding this *The Financial Age*, Sept. 19, 1914, p. 477, says:

"A pamphlet issued by the bank of Manhattan Company states that the banks of New York at the present time are confronted with practically the same problems with which they had to contend just one hundred years ago, or during the last year of the Napoleonic wars in Europe. It says:

"At the meeting of the General Committee on August 27, the spirit of co-operation among American bankers was evidenced in the following resolution:

"Resolved, that if any bank shall be called upon for a payment of specie beyond its present ability to pay, every aid shall be given by the other institutions consistent with their own safety.

"At this same meeting the General Committee also prepared regulations for the settlement of balances between banks to become effective September 1, 1814. The financial strain had evidently increased, and in spite of the strong effort to maintain specie payments, they had been suspended. The regulations

Clearing and Collection

The clearing and collection practices of the national banks were cumbersome and costly. In the settlement of inter-sectional trade balances banks commonly exacted collection and exchange charges, and where such were exacted they were commonly passed on to the business public directly or indirectly in higher interest charges. This was a heavy burden on the business public; and to the extent that the charges were absorbed by the banks they were an economic loss. In an effort to avoid paying these charges to other banks, bankers adopted the practice of circuitous routing of checks between correspondent banks aiming at par collection. This not only involved waste and delay but gave rise to a large volume of uncollected checks or float. As pointed out above though the banks counted this float as collected it in reality was a fictitious reserve. As such it was subject to considerable risk and in crucial times it proved to be irredeemable in cash. The absence of any centralized clearing mechanism for handling inter-city or inter-sectional claims necessitated heavy expense and trouble of shipping gold and currency.²⁵

Discount Market and Domestic Exchange

Under the national banking system there was no discount market of national proportions.²⁶ Due to the independent

are especially interesting. They make it evident that exactly 100 years ago during our own war with Great Britain and the Napoleonic wars in Europe, the New York banks found it necessary to work out an emergency system for settling their daily balances. This, without doubt, was the precursor of the system of Clearing House Loan Certificates, which, since the formation of the New York Clearing House in 1853, has been used in several crises, and is in effect at the present moment.' "

For a discussion of clearing house certificates and other practices of imparting a degree of elasticity to an inelastic currency see *Sound Currency*, Vol. II, No. 6, Feb. 15, 1895, and W. E. Spahr, *The Clearing and Collection of Checks*, chapter V.

²⁵ For details concerning the evils of the clearing and collection system see H. Parker Willis, *The Federal Reserve*, pp. 228-230; and W. E. Spahr, *The Clearing and Collection of Checks*, pp. 101-119.

²⁶ L. M. Jacobs, *Bank Acceptances*, Senate Document 569, 61st Congress, 2nd Session, published by the National Monetary Commission; J. Laurence Laughlin, Editor, *Banking Reform*, chapter VI.

unit bank system and the legal restrictions to which national banks were subject in the making of acceptances, the scope of the operations of commercial banks was, as a rule, quite naturally limited to their own communities. There was no standard commercial paper or bank acceptance available for the loans and investments of banks and this tended to cause the concentration of reserves in New York City. Consequently, there was extreme variation in the cost of capital in different parts of the country and lack of stability of interest rates.

There was no organization capable of assuring the furnishing of domestic exchange from one part of the country to any other part or able to prevent the disruption of the exchanges. Domestic exchange operations required the physical shipment of quantities of currency and coin, which involved much time, labor, expense, and the risks of transportation. As in the case of foreign exchange, the shipment of gold, or currency, was necessary in order to settle balances between various sections of the country. Exchange on distant cities was purchased at rates which fluctuated widely and constituted a burden on the business public.²⁷

The above conditions associated with the lack of a national discount market and the inadequate domestic exchange medium superinduced financial difficulties in good times and bad, hindered domestic trade and industrial financing, and accentuated the ill effects of sectional as well as national disturbances.

Foreign Exchange and Foreign Trade Financing

In the matter of foreign exchange and foreign trade financing we were for the most part dependent upon the London money market. Our foreign trade was largely financed abroad. This was probably fundamentally due to the fact that the United States was a debtor rather than a creditor nation and such trade could be financed more cheaply in London. But it was also due to the restrictions against creating acceptances to which American banks were

²⁷ For details concerning domestic exchange operations, see Ira B. Cross, *Domestic and Foreign Exchange*, chapters I, II, and III.

subject and the lack of foreign branches of American banks. The situation called for an additional foreign exchange operation which involved more expense and additional risk. Furthermore, foreigners secured information which handicapped American business men in competition with them.

Although there was a money market in New York, it was hardly an international one in the sense that the London money market was because a substantial rise in the discount rates of commercial banks did not succeed in attracting much foreign capital. There was no power to exert a decisive influence on gold movements by means of money rate changes or the settling of international balances by offering bankers' acceptances. Gold movements were too greatly influenced by stock market speculation and the call loan rate.²⁸

Treasury Operations

Since 1846, when the Independent Treasury was established, the Government had been custodian of its own funds. In the administration of these funds, the Government kept its money apart from the banking organization, locked up in its vaults in the Treasury building in Washington and in several sub-treasuries scattered over the country. To the extent that the Treasury deposited money in the banks, the deposits were ordinarily governed by political considerations. The Treasury's practice of receiving payment in cash for the most part and making its disbursements in cash resulted in periodic withdrawals from the banks which upset monetary and banking relationships. During periods of stringency which, indeed, its own operations had helped to produce, its effort to furnish relief tended to stimulate speculation and made it more difficult for banks to maintain their reserves. Unsatisfactory as was the experience of the Federal Government in being its own fiscal agent in time of peace, it made very difficult the collection and disbursement of revenue in time of war. And its operations could generally

²⁸See L. M. Jacobs, *Bank Acceptances*; J. Laurence Laughlin, Editor, *Banking Reform*, chapter XXII.

be counted upon to accentuate fluctuation in interest rates and unsettle business conditions.²⁹

Credit Control

Credit control under the national banking system was an impossibility. The thousands of independent unit banks worked at cross purposes. The least "scare" would cause each bank to strengthen its position by competing for the available gold because there was no central agency which would enable the banks to increase their reserves or secure bank notes to meet the increased demands of their customers for cash. No increase in the reserves of the commercial banking system was possible except that arising from domestic gold production or gold imports or perchance the habits of the people resulting in the deposit of gold coin in their banks. The contraction of bank credit was dependent upon putting gold coin into circulation or exporting gold. The independent bankers quite naturally developed correspondent bank relationships and these proved very insecure. There was no central bank or organization to coördinate the policies of the commercial banks of the country and to whom they might look for leadership in good times as well as periods of adversity. Economic life during the period of the national banking system became ever more specialized and groups and sections of the country became increasingly interdependent. In like manner international relations multiplied and became more complex. The use of deposit credit far outstripped metallic and paper money as a medium of exchange.

There was no institution which could survey lending policies from a national point of view and control the total amount of bank credit in use in relation to the gold base or any other criteria. A central authority was lacking which could regulate the flow of credit in and out of the money markets and the flow of gold between countries, marshal

²⁹ David Kinley, *The Independent Treasury of the United States and its Relation to the Banks of the Country*, Senate Document 587, 61st Congress, 2nd Session, published by the National Monetary Commission. See also *The New York Money Market*, Vol. I, by M. G. Myers, chapters IX and XVII.

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the financial resources of the nation to make a united front against a crisis whether it be one of war or business depression. In short there was no institution which was charged with the duty of being responsible for general credit conditions. The lack of such an institution, of course, constituted a vulnerable weakness of the national banking system. The defects of the commercial banking structure were inherent though they were patent more especially during crises. The injurious effects of the evils of the national banking system were not only inflicted upon the banks but in greater degree upon everyone else, the public, the producers, and consumers.³⁰

³⁰ Concerning the injuries suffered by the people of the nation, Carter Glass said: "While we may boast that no note holder has ever lost a dollar, and the losses of depositors constitute an inconsiderable percentage of the total liabilities of the banks, nevertheless, the failure of the system in acute exigencies has caused widespread business demoralization and almost universal distress. Five times within the last 30 years financial catastrophe has overtaken the country under this system; and it would be difficult to compute the enormous losses sustained by all classes of society, by the banks immediately involved; by the merchants whose credits were curtailed; by the industries whose shops were closed; by the railroads whose cars were stopped; by the farmers whose crops rotted in the fields; by the laborer who was deprived of his wage. The system literally has no reserve force. The currency based upon the nation's debt is absolutely unresponsive to the nation's business needs. The lack of coöperation and coördination among the more than 7,300 national banks produces a curtailment of facilities at all periods of exceptional demand for credit. This peculiar defect renders disaster inevitable." Speech in House of Representatives, Sept. 10, 1913. Congressional Record, Sept. 10, 1913, p. 4642.

CHAPTER II

ESTABLISHMENT OF THE FEDERAL RESERVE SYSTEM

The Banking Reform Movement

During the panic of 1893 such serious attention began to be paid to those defects of the banking system which had become manifest that this panic may be said to mark the beginning of the banking reform movement. At this time the Baltimore Clearing House drew up a plan which was presented to the convention of the American Bankers Association in Baltimore in 1894. This plan, which became known as the Baltimore plan, was modeled upon the Canadian system of guaranteed note issue and was concerned with making the paper money safer and more elastic.¹ The bankers' convention sponsored the plan and gave it publicity. In his report on the state of the finances, December, 1894, the Secretary of the Treasury, Mr. Carlisle, also urged a revision of our bank note issue.² During the ensuing period the question of reform of the bank note issue was submerged in the controversy over the unlimited coinage of silver.

A noteworthy step was taken in 1897 when the Indianapolis Monetary Commission, composed of bankers, business men, and economists, investigated the situation and issued a report.³ This report furnished the basis for a bill which was introduced in the House on January 6, 1898. Doubtless Congressional action was delayed on account of the Spanish-American War. The Monetary Commission had emphasized

¹ For the essentials of the plan see J. Laurence Laughlin, *Banking Progress*, p. 27. See also *The Commercial and Financial Chronicle*, Oct. 27, 1894, pp. 718-720.

² *Annual Report of the Secretary of the Treasury*, Dec. 3, 1894, pp. LXVII-LXXXIII.

³ *Report of the Indianapolis Monetary Commission*, 1898.

the desirability of asset currency. When the Gold Standard Act of 1900 was enacted some of the recommendations of the Commission became the law, but the revision of the method of issuing bank notes was not one of them. The prosperity of the time resulted in a relaxation of interest in the subject on the part of most of the banking and commercial people. Scientific students of the subject, however, continued their investigation and promotion of reform.

The effort for reform was generally known as the currency reform movement. It was not, however, confined merely to currency, which was popularly thought of as bank notes, and its elasticity. It referred to many other phases of banking including banking organization and credit control. "Currency reform" was a phrase which became more or less traditional from the time of the Baltimore plan following the panic of 1893 and covered the general revision of the banking structure of the country as it was discussed. Throughout the entire reform movement including the period of debate on the Federal Reserve Act itself, newspapers, magazines, and scientific societies generally referred to the matter as "currency reform." In its inception the movement had to do with a revision of the issue of bank notes but about the beginning of the century commonly involved a modification of the whole banking structure. Indeed, previous to the Gold Standard Act of 1900, Maurice L. Muhleman had proposed a central bank of issue.⁴ It became evident that mere currency reform was not enough but that what was needed was a change in the organic structure of the banking system.

Hence it developed that the inauguration of central banking in the United States, which had long been so unpopular politically, was seriously urged at the beginning of the century by the younger school of economists. The change in the nature of the so-called "currency reform" discussion had progressed so far that by 1902 banking reform was analyzed under the title of "The Demand for Centralized Banking." This analysis by an authority who, a decade later, was economic adviser of the House Banking and Cur-

⁴ Maurice L. Muhleman, *Monetary and Banking Systems*, p. 206.

rency Committee in the formulation of the Federal Reserve Act, contained a summary of the situation as follows: ⁵

Until recently, most of those who have written on the subject have been very certain that what the country needed was a better equipment of small and branch banks. Most of the arguments on currency reform dealt with this question at greater or less length, apparently assuming that, should permission to establish branches be conceded, a long step toward the improvement of currency conditions would have been taken. The change in the trend of the discussion may be outlined as follows:

1. It is now assumed or stated, by many writers and speakers that the subdivision of banking capital has gone far enough, for the time, at least.
2. It is argued that, whether or not the establishment of branches should be permitted to institutions of large capitalization, this innovation is not what we now need, but that the next step to be taken is rather the coördination of the parts of the existing banking mechanism.
3. Stress is being laid upon the need for some central bank which should consolidate the credit institutions of the country, and which, according to some, should take over certain Treasury functions or be entrusted with certain new functions, such as the exclusive right to issue notes based on commercial assets.

The discussion regarding centralization encompassed a number of ideas, but it was pointed out by Dr. Willis that "in order to attain centralization in banking in the United States it is necessary to introduce into our banking system such changes as will result in satisfying two requirements, concentration of reserves and concentration of control; and that any changes which secure that result will ipso facto introduce a centralized system of banking." ⁶

In the period between 1900 and the panic of 1907 a number of proposals for banking reform were offered. Some of these were then or a little later introduced in Congress but the reaction to them all was that they were premature or unconvincing. The panic of 1907, however, was a powerful impetus to the talk of revising our banking system. The result was the passage of the Aldrich-Vreeland Act of June 30, 1908.⁷ This Act provided for the issuance of a

⁵ H. Parker Willis, "The Demand for Centralized Banking," *Sound Currency*, Vol. IX, No. 1, March, 1902, pp. 1 and 2.

⁶ *Ibid.*, p. 6. ⁷ See J. Laurence Laughlin, *Banking Progress*, chapter IV.

temporary emergency currency⁸ and for the appointment of the National Monetary Commission consisting of sixteen members of both houses of Congress. The Commission was charged to carry on an investigation of banking systems and make a report to Congress with a view to the ultimate adoption of a permanent reform measure. It made an extensive investigation of the regulations, principles, and practices of financial institutions in the more important countries. The results of its research were published in a series of many volumes, which included the individual work of several experts in their fields. The consequence was an equipment of technical material of service in formulating a banking system adapted to American conditions.⁹

The Aldrich Plan and the National Citizens League

Following the panic of 1907 there was more widespread discussion of the questions at issue. The Secretary of the Treasury, Leslie M. Shaw, said: "Financial panics in this country have caused more mental and physical suffering than all the plagues known to man."¹⁰ The country became aroused to the need of reform. Many organizations, such as scientific societies, forum clubs, chambers of commerce, produce exchanges, merchants and bankers associations, gave more or less attention to the subject.¹¹ The National Monetary Commission headed by Senator Aldrich was scheduled to present its report "early in 1911 following the congressional elections in the fall of 1910."¹² But owing to

⁸ For details see the following: Report of the Comptroller of the Currency, Dec. 6, 1915, pp. 44-45, 94-101; J. Laurence Laughlin, *Banking Progress*, chapter IV; H. J. Dodge, "The Aldrich-Vreeland Emergency Currency," *The Annals of the Academy of Political and Social Science*, January, 1922, p. 49.

⁹ Report of the National Monetary Commission, Jan. 8, 1912, Senate Document 243, 62nd Congress, 2nd Session. For details concerning the work of the National Monetary Commission, see N. A. Weston, "The Studies of the National Monetary Commission," *The Annals of the American Academy of Political and Social Science*, January, 1922, p. 17.

¹⁰ Annual Report of the Secretary of the Treasury, Dec. 3, 1908.

¹¹ Regarding the details of efforts at reform see Willis, *The Federal Reserve*, chapters II and III; Willis, *The Federal Reserve System*, chapters I-VII; Willis, "The Banking Question in Congress," *The Journal of Political Economy*, Vol. 20, November, 1912, pp. 869-885.

¹² Congressional Record, Sept. 12, 1913, p. 4824.

the reverses suffered in the House of Representatives in the 1910 elections by the administration in power, Senator Aldrich's report was delayed.¹³ The reason for the delay was apparently not generally understood in Congress inasmuch as there was considerable impatience and the Commission was accused "of withholding its report for the purpose of continuing salaries."¹⁴ The report was postponed because it was considered an inopportune time to present it since the administration faced an unfriendly public and time was needed to make a canvass of the new House of Representatives and "provide for their special advisement in financial matters."

Rather than make the Monetary Commission report public, it was decided to carry on first an "educational campaign" among the people. For this purpose it was determined to launch a new organization to undertake the task of preparing the public for a ready acceptance of the Aldrich bill for a central bank. In order that the impetus of this campaign might appear to come spontaneously from the business men of the country, the National Board of Trade met in Washington, D. C., in January, 1911, to consider "currency reform."¹⁵ Senator Aldrich reported the first draft of his bill, intended for the National Monetary Commission, to the Board of Trade, copies of it being already in the hands of the delegates the day preceding the conference. On January 18, 1911, the Board of Trade authorized the chairman "to appoint a committee to organize a 'Business Men's Monetary League' with headquarters in Chicago and branches throughout the country, to conduct a comprehensive campaign of education in behalf of some kind of a national reserve association."¹⁶ In order to overcome prejudice against the efforts of the League, the backers of the Aldrich plan decided that its headquarters should not be located in New York City, and selected Chicago.¹⁷ This was

¹³ *Idem.*

¹⁴ *Idem.*

¹⁵ J. Laurence Laughlin, *The Federal Reserve Act: Its Origin and Problems*, p. 59; Congressional Record, Sept. 12, 1913, p. 4825.

¹⁶ Laughlin, Editor, *Banking Reform*, p. 419.

¹⁷ Laughlin, *The Federal Reserve Act: Its Origin and Problems*, p. 59.

considered by the chairman of the executive committee of the League, Professor J. Laurence Laughlin, "good strategy."¹⁸ They promised to give the Chicago organization financial support if it undertook the task.¹⁹ Accordingly the committee was appointed, met in Chicago on April 26, 1911, and got the Chicago Association of Commerce to appoint a group of men to organize the League.²⁰ The organization effected had a lengthy and imposing title and an extensive program. It was called "The National Citizens League for the Promotion of a Sound Banking System." The certificate of incorporation which was granted June 6, 1911, reads, "The object for which it is formed is to give organized expression to the growing public sentiment in favor of, and to carry on a campaign of education for, an improved banking system for the United States of America."²¹ A nationwide campaign was conducted by the League from its headquarters in Chicago designed to inform the public concerning the issues of banking with a view to securing favorable action by Congress.²²

Senator Aldrich submitted his plan for a central bank, which he termed a "plan for monetary reform," to the Monetary Commission in January, 1911.²³ Finally, after a year's postponement and after being revised somewhat, it was introduced in Congress on January 8, 1912, together with the report of the Commission.²⁴ It was called a bill "to incorporate the National Reserve Association of the United States" in order to avoid the idea that the institution which it sought to establish was a central bank. The bill was not favorably received and was not even reported out of committee. Though the bill as such was not debated in Congress there continued an energetic campaign for its

¹⁸ *Idem.*

¹⁹ *Idem.*

²⁰ Laughlin, Editor, *Banking Reform*, pp. 419-420.

²¹ "The Origin of the League," published by the National Citizens League.

²² See A. D. Welton, "The Educational Campaign for Banking Reform," *The Annals of the American Academy of Political and Social Science*, January, 1922, p. 29; Laughlin, *The Federal Reserve Act: Its Origin and Problems*, Part I.

²³ Senate Document 784, 61st Congress, 3rd Session.

²⁴ Senate Document 243, 62nd Congress, 2nd Session.

adoption especially by New York bankers and the American Bankers Association. The New York bankers, working with the American Bankers Association, used the National Citizens League as a vehicle for the promotion of the acceptance of their ideas among the country bankers and people generally.²⁵ An illustration of the coöperation between the League and the New York bankers who were backing the Aldrich plan of a central bank is furnished by the following letter.²⁶ This letter was sent out by the Chase National Bank to its correspondents in the interior in the early part of 1912.

The Chase National Bank,
New York, February 21, 1912.

GENTLEMEN:

We enclose a letter from the National Citizens League, which we have been asked to forward to you. The campaign of education which the League is conducting in favor of currency and banking reform is non-partisan in character and national in scope. We believe it of direct importance to the business interests of the country. The merchants interested in the work have felt that while they regard themselves as responsible for the raising of funds for the prosecution of the work, the country at large should know that the banking interest is in sympathy with the work. Any correspondence should be taken up with Mr. Isidor Straus, treasurer, Broadway and Thirty-fourth Street, New York, and any contributions made direct to him.

Yours sincerely,
A. H. WIGGIN, President

The League did not put forward a legislative proposal of its own but it regarded the Aldrich bill favorably. It approved of its principles²⁷ and carried on an intensive effort for their adoption. Indeed, it was understood at the time of the annual convention of the American Bankers Association

²⁵ The Commercial and Financial Chronicle, Bankers Convention Section, Dec. 2, 1911, p. 109; Report of the Currency Commission of the American Bankers Association, submitted to the American Bankers Convention at Detroit, Sept. 10-13, 1912, published in The Commercial and Financial Chronicle, Bankers Convention Section, Sept. 21, 1912; Congressional Record, Sept. 12, 1913, p. 4824.

²⁶ Congressional Record, Sept. 12, 1913, p. 4824. In connection with the content of this letter, see the material in this chapter to which footnote 15 is a reference.

²⁷ Congressional Record, Sept. 12, 1913, p. 4824.

in November, 1911, that the convention vote for the Aldrich bill was to be followed by an aggressive "campaign of education" under the auspices of the National Citizens League.²⁸

The Passage of the Federal Reserve Act

In the meantime the political complexion of Congress changed from Republican to Democratic. The banking question was a vital issue²⁹ in the presidential campaign of 1912 which resulted in the election of Woodrow Wilson, the candidate of the Democratic party. Wilson became President March 4, 1913. He desired an immediate change in the banking laws and set about to secure it. On June 23, 1913, President Wilson delivered a special message on banking reform to Congress in which he said:

We must act now, at whatever sacrifice to ourselves. It is a duty which the circumstances forbid us to postpone. I should be recreant to my deepest convictions of public obligation did I not press it upon you with solemn and urgent insistence. And the control of the system of banking and of issue which new laws are to set up must be public, not private; must be vested in the Government itself, so that the banks may be the instruments, not the masters, of business and of individual enterprise and initiative. I have come to you to urge action now.³⁰

On June 26, 1913, Carter Glass, chairman of the Committee on Banking and Currency of the House, introduced a bill, which had been in process of preparation by that Committee for some time, beginning in March, 1912. There developed a conflict between those who favored the Aldrich bill and those who favored the Glass bill.³¹ The Executive

²⁸ The Commercial and Financial Chronicle, Bankers Convention Section, Dec. 2, 1911, p. 109.

²⁹ President William Howard Taft, the candidate of the Republican party, in referring to the importance of banking reform declared: "It is more important than the tariff, more important than conservation, more important than the question of trusts and more important than any political legislation that has been presented." Quoted in the Congressional Record, Sept. 10, 1913, p. 4643.

³⁰ The Commercial and Financial Chronicle, June 28, 1913, pp. 1806-1807.

³¹ For details concerning the legislative history of the Act, see Willis, "The Federal Reserve Act in Congress," *The Annals of the American Academy of Political and Social Science*, Vol. XCIX, January, 1922, p. 36; Willis, *The Federal Reserve System*, chapters VII-XXII.

Committee of the American Bankers Association had approved the Aldrich bill, May 2, 1911. The American Bankers Association at its annual meeting in New Orleans, in November, 1911, voted unanimous approval of the Aldrich plan in all its details.³² The bankers continued to support that plan and when the Glass bill was proposed they and those congressmen who went along with them waged determined opposition to the enactment of the Federal Reserve Act and a bitter fight ensued.

The Federal Reserve Act was opposed not only by bankers but by various business organizations largely dominated by the larger banking interests and by some writers on economic and financial questions.³³ The National Citizens League which before had favored the Aldrich plan now came out openly in condemnation of the Owen-Glass bill.³⁴ In so far as the real origin of the National Citizens League was found in the purposes of the backers of the Aldrich plan to obtain ultimate passage of the Aldrich bill, those backers failed to achieve their purposes. The League did, however, render very considerable service in providing the people with technical material concerning the defects of the national banking system and by informing them about banking and currency problems of the day. It was the most ambitious effort to mold public opinion made during the banking reform period.

The fight for the Aldrich plan was not successful. This plan³⁵ provided for a central bank called the National Reserve Association of the United States with a head office in Washington, D. C., and fifteen branches located in financial centers. The charter was to run for fifty years. Stock in the central bank was to be held by the banks. Control was vested in the banks and primarily in the larger

³² The Commercial and Financial Chronicle, Bankers Convention Section, Dec. 2, 1911, pp. 109, 194; Sept. 21, 1912, p. 108.

³³ Journals, magazines, and newspapers of the period are filled with opposition to the Act. Consult also The Commercial and Financial Chronicle, Bankers Convention Section, Sept. 21, 1912, p. 148; Willis, *The Federal Reserve System*, chapters XIV-XVIII.

³⁴ The Financial Age, July 12, 1913, p. 53.

³⁵ Senate Document, No. 243, 62nd Congress, 2nd Session, p. 43.

ones because voting rights were to be in proportion to the capital stock owned by the banks. State banks as well as national could purchase stock. It retained the reserve requirements of the national banking system.

The National Monetary Commission or Aldrich plan was rejected because it was generally believed that it meant too great a centralization of power in the hands of the "financial interests" of Wall Street. The feeling of the public was that banking is so vitally connected with the welfare of all classes in the country that it was unreasonable and unsafe to allow a banking system to be controlled so largely by one class—the bankers.³⁶ It was felt that the banks handle other people's money and control the credit necessary for the success of the business and agricultural classes and that the Aldrich plan did not allow other interested parties and especially the Government an adequate share in the management of the system. Simultaneously with the Glass committee working on the new bank act was the Pujo committee carrying on the "Money Trust Investigation." A highly centralized organization and control of financial power was brought to light in this investigation.³⁷ The fact that interests identified with the so-called "Money Trust" were favorable to the Aldrich plan and that these same interests were to be the chief powers in the proposed organization, caused people to be suspicious of the ulterior purposes of its backers and fearful of the power of exploitation which they believed would be handed over to this group if the Aldrich plan were adopted.

The results of the "Money Trust" investigation accentuated the aversion to this type of central bank. Another objection to the Aldrich bill was that, though the plan provided for branches in various cities of the country, it was

³⁶ George M. Reynolds, president of the Continental and Commercial National Bank of Chicago at the time, said: "I believe the money power now lies in the hands of a dozen men; and I plead guilty to being one, in the last analysis, of those men." Hearings in the Money Trust Investigation, p. 1657.

³⁷ Report of the committee appointed pursuant to House Resolutions 429 and 504 to investigate the Concentration of Control of Money and Credit, submitted by Mr. Pujo, Feb. 28, 1913, House Report No. 1593, 62nd Congress, 3rd Session.

believed that they would not be sufficiently autonomous to meet the needs of the diverse economic conditions in the various regions, adopt a policy in the interests of each district, and serve the people effectively. Being merely branches it was felt that they would be dominated by the central bank which would mean the "financial interests" in New York.³⁸ Furthermore, it did not remedy the series of evils involved in the reserve city deposit system. In short the Aldrich central bank plan was patterned too much after the European central banks and was defeated because it was not adapted to American conditions, geographical and economic, and was contrary to the American tradition of local autonomy and of opposition to centralized financial power in private hands which had persisted from the days of the Second Bank of the United States.

The bill which Carter Glass introduced on June 26, 1913 ran the gamut of conference and revision. With some few modifications introduced by the Senate Committee headed by Senator Owen, it was known as the Owen-Glass bill. On December 23, 1913, the Federal Reserve Act was signed by President Wilson and became the law.³⁹ The Federal Reserve Act differed from the Aldrich bill in several important particulars.

How the Federal Reserve Act Differed from the Aldrich Bill

1. The Aldrich bill provided for one central bank for the whole United States with fifteen branches, all the gold reserves of which would be in one place. The Federal Reserve Act authorized a central banking system consisting in part of several regional central or reserve banks, each with its own gold reserve located in its own bank. It provided for branches of each Federal Reserve bank.

2. The Aldrich bill provided for a uniform discount rate the country over, opposing any differences as between

³⁸ E. W. Kemmerer, "Banking Reform in the United States," *American Economic Review Supplement*, Vol. III, March, 1913; E. W. Goodhue, *ibid.*, p. 79; Speech of Senator Owen in United States Senate, *Congressional Record*, Nov. 24, 1913, p. 5993; Willis, *The Federal Reserve*, pp. 82-83; Willis, *The Federal Reserve System*, pp. 83-85.

³⁹ Public Act, No. 43, 63rd Congress.

various sections. The Federal Reserve Act provided for regional banks sufficiently autonomous so that they could adjust themselves to the diverse economic conditions in various sections of the country and adopt a policy in the interests of each district, such as, for example, the important policy regarding discount rates.

3. The Aldrich plan retained the old system of pyramided reserves and proposed to leave undisturbed the great concentration of bank balances in New York. It made no provision for centralization of legal reserves of members of the association. The Federal Reserve plan provided for centralized legal reserves in the regional banks.

4. The Aldrich bill provided a plan whereby upon rediscounting a member bank would receive the central bank legal tender notes which it could count as a part of its own reserve. That plan would tend to prevent the contraction of the notes and promote inflation by making them the basis for the manufacture of bank credit. On the other hand, the Federal Reserve Act provided that Federal Reserve notes could not be counted as a part of the legal reserves of member banks. Thus, under this Act, Federal Reserve notes could not be made the basis for the creation of bank credit by member banks and the contraction of the notes would be facilitated. Whereas that provision of the Aldrich bill involved an expansion of the note issue, the Federal Reserve Act provided for an elastic note issue.

5. Membership in the National Reserve Association was made voluntary while the Federal Reserve Act *required* national banks to be members of the Federal Reserve system or forfeit their charters.

6. The Aldrich bill did not make specific provision for remedying the old clearing and collection evils. The Federal Reserve Act provided for eliminating such evils and requiring uniform and moderate exchange charges.

7. The Aldrich bill would have set up a reserve of the central bank which would have been inactive since it was not to be the basis for the regular clearing and collection of items drawn against the banks. The Federal Reserve Act on the other hand provided that the reserves of the Federal

Reserve banks and the reserve deposits of member banks in the Federal Reserve banks be active, that is, funds would flow in and out of the Federal Reserve banks as a result of the receipt and collection of claims upon other banks.

8. The central bank under the Aldrich bill was designed to function as a bank for emergency relief to the members of the association. In this respect, also, its reserve was to be inactive. Credit was a kind of passive affair to be advanced primarily to prevent a panic or to "help out" a hard pressed bank. In the case of the Federal Reserve, while all emergency requirements of the commercial banks were to be met, the view of a central banking organization functioning actively as a credit control institution in order to stabilize conditions in the money market, to lessen the *causes* of the troubles which had confronted the American banking system and to prevent the emergencies from arising, was embodied in the Federal Reserve Act. Moreover, credit was to be expanded or contracted with a view to influencing general financial conditions, or the superstructure of credit. There were several provisions of the Federal Reserve Act designed to facilitate these ends, the chief of which were the rediscounting clauses and those authorizing the broad open market powers of the Federal Reserve banks including the purchase of two-name commercial paper directly from the business concerns.

9. Finally, in addition to all of these differences of principle and organization, there is the marked difference in the controlling authority. The Aldrich bill would have set up a central bank controlled by the bankers, exercising in turn control over the credit its branches would receive. On the contrary under the Federal Reserve Act there was established a central banking system with a Federal Reserve Board composed entirely of United States Government representatives as the central authority. It also provided for substantial government representation on the boards of directors of the Federal Reserve banks. Moreover, these regional banks had immediate control of their own credit policy but ultimate power and control over all of them was vested in the government Federal Reserve Board.

The differences indicate that in these fundamental provisions the Aldrich bill was the very antithesis of the Federal Reserve Act.

The Federal Reserve Act and Central Banking

The Federal Reserve Act was the climax of a quarter-century of educational effort for the reformation of the banking system which began during the depression in 1893. The framers of the Act deduced from American experience principles and practices which were calculated to be useful in removing the defects of the national banking system. These, together with those of European countries, they welded into a coherent whole in such a way as to fit American conditions and meet the requirements of the American people. The general demand for an elastic currency, which furnished the inception for the banking reform movement, was met essentially by the requirements that legal reserves be centralized, that they consist of deposit credit on the books of regional Reserve banks, and that they be mobile. In addition to furnishing elasticity to bank credit, these requirements were also formulated to protect solvent banks against runs on the part of depositors. The combining of reserves was not an end in itself but a means to ends. The idea of a central reserve is found in early American experience. It may be traced back to the New England Bank of Boston⁴⁰ and then through the Suffolk banking system,⁴¹ wherein each member bank kept a reserve on deposit with the Suffolk Bank in Boston for the purpose of redeeming its bank notes at par.

Thereafter we find the reserve plan developing in the so-called correspondent banking system as it spread out over the country, which, with the enactment of the National Bank Act, was carried over in the national banking system. Finally, the reserve principle was utilized for emergency purposes by the local or district clearing house associations.⁴² But with the establishment of the Federal Reserve

⁴⁰ Knox, *A History of Banking in the United States*, p. 365.

⁴¹ *Ibid.*, pp. 365-368.

⁴² See chapter I, footnote 24, regarding the issue of clearing house certificates.

system the principle of combining reserves to achieve certain ends attained further development in our national economy. Instead of being a temporary arrangement it was incorporated as a continuing factor in our banking organization; and instead of serving a more or less local area, it was applied to the whole United States. So far as the regional organization and centralization of legal reserves in several centers are concerned, the framers of the Federal Reserve Act made an ingenious adaptation to the banking sphere of a fundamental aspect of the American constitutional system—a combination of local self-government and federal authority. Though, of course, they did so for reasons pertinent to existing financial conditions and banking principles.

President Wilson played an effective part in the Reserve Act ⁴³ and credit to him for this banking reform measure may be based on three counts:

1. His indomitable purpose to give the nation a new banking system and his demand for immediate legislation.

2. His political leadership, along with his understanding and support of the Federal Reserve Act, which reconciled the differences among various factions and secured the united support of his party for the Act.

3. His requirement and unequivocal stand in the face of determined opposition that the controlling authority of the Federal Reserve system be entirely governmental, without private representation.

⁴³ Carter Glass, Introductory Statement of, in Willis, *The Federal Reserve System*, p. ix.

At the conclusion of the signing of the Federal Reserve Act, President Wilson said: "All great measures under our system of government are of necessity party measures for the party of the majority is responsible for their origination and passage, but this cannot be called a partisan measure." *The Commercial and Financial Chronicle*, Dec. 27, 1913, p. 1866.

Charles S. Hamlin, the first governor of the Federal Reserve Board, in an address before the New York Chamber of Commerce in 1914, referring to the Federal Reserve Act, said: "Its underlying principles were not invented or newly created, but are the result of years of discussion and study. I can say this with confidence, however, that no selfish interests assisted at its birth. I can further state that beyond those primarily responsible for its provisions . . . there looms up one figure more entitled to the credit for its provisions than any of the others, the President of the United States, Woodrow Wilson." *The Commercial and Financial Chronicle*, Dec. 5, 1914, p. 1634.

The purposes of the framers of the Federal Reserve Act were several. Consideration will be given to these purposes in succeeding chapters. According to the title of the Act, their purposes were "to provide for the establishment of Federal Reserve banks, to furnish an elastic currency, to afford means of rediscounting commercial paper, to establish a more effective supervision of banking in the United States, and for other purposes."⁴⁴ The Federal Reserve Act was designed to remove the defects of the national banking system from our economic life. As a constructive measure it was designed to establish an institution to carry on the functions of central banking. The institution which it set up was not a central bank but it was a central banking system.

A Central Banking System

The central banking system established in 1914 consisted of thirteen parts, the Federal Reserve Board and twelve Federal Reserve or district central banks. There was also authorized and set up a Federal Advisory Council as an adjunct to the system. The Federal Advisory Council is an organization composed of one representative from each Federal Reserve district, elected by the board of directors of the respective Reserve banks, and meets with the Federal Reserve Board four times a year. It was designed to enable the banking interests to give organized expression of their views to the Federal Reserve Board, to call for information about Federal Reserve problems, and make recommendations thereon. The Federal Reserve Board consists of eight⁴⁵ members, including the Secretary of the Treasury and the Comptroller of the Currency as ex-officio members, and six appointed by the President of the United States. It is a central board of directors of the banking system, not an operating bank. The banking functions are exercised by the Federal Reserve banks. Over these banks the central board has had powers of examination and supervision, the veto

⁴⁴ Public Act, No. 43, 63rd Congress, Dec. 23, 1913.

⁴⁵ The Federal Reserve Act as amended June 3, 1922. The original Act provided for seven members.

power over some of their important functions, and extensive authority over their expenses and personnel.

From this point of view the Reserve banks are the head banking offices of the Federal Board. While each Reserve bank was to carry on actual banking operations and have a certain control over affairs in its own district, the Federal Board was to provide central coördination and management so far as concerns the common interests of the Reserve banks and monetary and banking policies national or international in scope and influence. Thus the Act provided for governmental control over the commercial banking system of the United States. Hence centralization of control was intended and provided by means of the Federal Reserve Board.

The Act was intended to bring about a certain decentralization of banking resources so far as the nation was concerned; but to centralize legal reserves so far as each district was concerned and to provide for the inter-district mobility of them through centralized government control in the Federal Reserve Board. Thus centralization of reserves was introduced into our banking organization.

There is unity of reserves in each Federal Reserve district. There is also unity of reserves in the nation, the Act providing that the Federal Reserve Board may require one Federal Reserve bank to rediscount the paper held by another. The Federal Reserve system may properly be called a central banking system in that (1) the reserves are centralized in each district and the Federal Reserve Board is a central board coördinating and supervising the work of the Reserve banks even to the extent of making the reserves of one Federal Reserve district available for use in any and all other districts; (2) so far as concerns policies affecting general economic conditions, national interests, or affairs of international scope are concerned, the Federal Reserve Board was established as the central authority of control; and (3) the system's policies are to be determined with a view to attaining various public ends rather than making profits.

From the point of view of the national economy the Act did not provide for a single central bank. It provided for a chain of Reserve banks each of which in conjunction with the

Federal Reserve Board is the central bank of its district. The intention of the framers of the Act was to make each Reserve bank in the chain independent of the others and to preclude the existence of any outstanding Reserve bank which would overshadow the Federal Reserve system. Though each district central bank in the chain was to be independent of the authority of every other one, each bank was to be under the authority of the Federal Reserve Board. The Federal Reserve Board was made not only the higher authority over each Reserve bank but a central controlling authority of the Federal Reserve system.⁴⁶

⁴⁶ The passage of the Federal Reserve Act was the occasion for widespread comment at the time both at home and abroad. Probably no banking act in the history of this or any other country ever evoked such praise or condemnation or such international interest as the Federal Reserve Act. Examples of such are these:

Doctor Richard Hauser, of the Deutsche Bank of Berlin, issued a statement in which he said: "The American Act is one of the greatest undertakings that has ever been attempted in the realm of banking, surpassing the English reform of Sir Robert Peel in 1844. . . . In no instance has such an aggregation of capital had opened to it such new forms of opportunity. . . . It will depend entirely upon whether the united regional banks, acting as a reserve power, will be able to make adequate use of the unusual powers committed to them, and also whether responsible men of integrity and efficiency are selected for the management." Quoted by R. H. Treman, president of the New York State Bankers Association, at New London, Conn., June 11, 1914. *The Financial Age*, June 19, 1914, p. 1040.

A prominent economist stated: "Next to the Declaration of Independence and the Constitution of the United States, the Federal Reserve Banking Act may prove to be the most important measure ever placed before the people of the United States because upon its wise administration depends the good or ill of one hundred million people in the material affairs." Quoted by R. H. Treman, *idem*.

CHAPTER III

THE PROBLEM OF DISTRICTING AND THE LOCATION OF FEDERAL RESERVE BANKS

The Reserve Bank Organization Committee

To effect the establishment of the new banking organization, the Federal Reserve Act provided for a committee to be known as "The Reserve Bank Organization Committee," consisting of the Secretary of the Treasury, the Secretary of Agriculture, and the Comptroller of the Currency. The first problems which confronted this committee were those of districting and the location of the Reserve banks. The problem of districting was a new one in central banking. European governments had no such problem and for two reasons. Their central banks had evolved gradually from commercial banks over a period of decades. Also, the size of European states was so small that one central bank was considered sufficient for their respective territories.

While the Federal Reserve Act was under discussion in Congress, no provision was more fiercely fought than the one calling for a division of the United States into districts, each with a Reserve bank of its own. This proposal was the object of scorn and ridicule and it was pronounced "impossible." The basis of the opposition was the anxiety of the New York bankers who desired not to disturb the old correspondent banking relationships and not to lessen the concentration of funds in New York City. Also some of the New York banks had ambitions to become central banks themselves.¹

The problem before the Organization Committee was one of drawing the district lines in such a way that each Reserve bank could carry on central banking functions. The Federal Reserve Act directed this committee to "designate not less

¹ Willis, *The Federal Reserve System*, p. 562. See chapter VII, pp. 136-137.

than eight nor more than twelve cities to be known as Federal Reserve cities," and to "divide the continental United States, excluding Alaska, into districts, each district to contain only one of such Federal Reserve cities." The districts were to be drawn "with due regard to the convenience and customary course of business" and their boundaries were not required to be "coterminous with any state or states." Pursuant to authority conferred in the Act, the Organization Committee set to work immediately after the passage of the Act. It secured the services of experts and inaugurated a nation-wide survey preparatory to its determination of Reserve bank cities and district lines.

It was announced that hearings would be held in strategic centers. A number of cities were anxious to be designated as the headquarters of a Reserve bank and the Committee sought to afford applicant cities every reasonable opportunity to furnish evidence to support their claims as locations for Federal Reserve banks. New York was decided upon as the city in which to commence the hearings. A member of the Treasury department went in advance and made all arrangements for the hearings such as securing the quarters and scheduling the hour of appearance of the witnesses in order to avoid congestion and conserve the time and interests of those who wished to testify. Special invitations to appear were extended to a representative list of persons, including members of the clearing house, bankers of New York, Jersey City, Newark, and various up-state cities and towns, and representatives of commercial organizations. In addition the Committee announced that it would listen to any other banker or business man who wished to appear before the Committee and make a statement.² The hearings in New York covered a period of three days, January 5, 6, 7, 1914. There were present at all meetings, Secretaries McAdoo and Houston who comprised a majority of the Reserve Bank Organization Committee, and they were assisted by Milton C. Elliot of the Treasury department, and Martin Vogel, Assistant Treasurer of the United States, representing the Government.

² The New York Times, Jan. 2, 1914, p. 24.

The Size of the New York District

The Organization Committee set forth two questions, to which the hearings ³ were to be addressed. These questions were:

1. Should a Reserve bank be organized in New York, and if so, why?
2. If a Reserve bank is organized in New York, what territory should such a bank serve?

In answer to the first question some concise facts were given as follows:

"New York is by far the most important manufacturing city in America, the value of its annual output being more than two billion dollars, or one tenth of the product of the entire United States in 1900.

"It has twenty-one separate industries the yearly output of each of which is more than twenty million dollars.

"It has over 25,000 separate factories, employing over 700,000 operatives.

"One fourth of the population of the United States is located within a radius of two hundred miles of this city.

"About 27½% of the export and import business of the entire United States is carried on through this port and financed by this city.

"While 27½% actually passes through the port of New York, there is probably over 70% actually financed here. There is a great deal of cotton movement in the South, and a great deal of the business done through Baltimore, Boston, Philadelphia, and other nearby ports that is practically financed through New York.

"About 60% of the bank clearings of the entire United States are credited to New York banks.

"The mere statement of these figures, showing the extent of New York's manufacturing, distributing, and export trade, shows conclusively why a regional bank should be established here."

The Organization Committee was not disposed to question these facts nor argue with any of the witnesses about the claims of New York for a Reserve bank. It was recognized

³ Nearly all material in this chapter concerned with the hearings was secured from the Stenographic Minutes of the hearings before the Reserve Bank Organization Committee. Use was also made of Senate Document 485, 63rd Congress, 2nd Session, 1914—Letter from the Reserve Bank Organization Committee transmitting the briefs and arguments presented to the Organization Committee of the Federal Reserve Board relative to the location of Reserve districts in the United States.

that New York was the largest manufacturing center, the largest export and import center, and the financial center of the country. In fact the hearings were conducted largely upon the assumption that a Reserve bank would be located in New York and the whole discussion revolved around the question: How large an area should be attached to the New York Bank? As to this question there was considerable difference of opinion. The following proposals indicate the range and diversity of opinion among the witnesses as to the scope of the district attached to New York:

1. All territory north of the Potomac including all of Pennsylvania.
2. New York, New England, New Jersey, Delaware, and Pennsylvania.
3. New York, New Jersey, New England, and Pennsylvania.
4. New York, New England, and northern New Jersey.
5. New York and all of New England.
6. The Metropolitan area of New York City, including Manhattan Island, Long Island, Westchester County in New York, and in New Jersey, Bergen County contiguous to the Hudson River, and Hudson and Essex Counties contiguous to New York Bay.

In addition to these proposals there were some which did not set forth definite boundary lines. One witness advocated what he called the shoe-string plan. This plan involved a division of the country into strips with a view to securing a diversity of economic interests in each strip. He said that the strips should run north and south for in this way they would include the cotton states as well as the business interests of the North. This witness also thought that it was of no great importance how large an area was attached to New York, because, "so far as diversity of interest is concerned, New York is the United States in a variety of aspects."⁴ One enthusiast for equalizing the power of the Reserve banks went so far as to propose that there should be no Reserve bank located in New York but that Reserve banks should be located in Boston and Philadelphia and the

⁴ Frank A. Vanderlip, president of the National City Bank of New York, *The New York Times*, Jan. 6, 1914, p. 19.

dividing line between these two districts should be along Broad Street of New York City.⁵ Another proposal of similar type was that a Reserve bank be located in the Wall Street district but its territory should be restricted to that area south of about 14th Street. That part of Manhattan Island north of this together with some adjacent territory should be allocated to a separate Reserve bank.

As is evident from the list of proposals, the area witnesses thought the New York district should include ranged from the very large, all the northeastern states, to the very small, the metropolitan area of New York City, and even merely the Wall Street district. Most of the discussion centered around the question of whether the northeastern states should be included in the territory assigned to the New York Bank or whether other banks should be located at Philadelphia and Boston, or either city. This was an important question because upon it depended the size and power of the New York Reserve Bank. This was so because of the way in which the capital of the Reserve banks was to be obtained.

The Act provided that national banks shall subscribe to the capital an amount equal to 6 per cent of their capital and surplus, one-half of which or 3 per cent was to be paid within a few months after the organization of the Reserve banks and the other half upon the call of the Federal Reserve Board. A few witnesses believed that a bank should be located at Boston to serve all or most of New England, while one thought that no harm would be done to New York if a bank were established in Boston, yet he stated that Boston would be better off as a part of the New York zone. A member of a commercial paper firm supported Boston. He believed it made no difference to New York how small a territory was attached to it. He said in effect that Boston is the center of a manufacturing area and has a class of commercial paper peculiar to it. They understand it better than anyone else. Ever since the Suffolk banking system was established they have had very intimate relations with a large number of banks in New England.

In opposition to the establishment of a Reserve bank in

⁵ The New York Times, Jan. 6, 1914, p. 19.

Boston, a large bank advocate stated that the question of knowing financial paper was not material because a branch bank in Boston could be in touch with local conditions and could learn the credit standings. The witness who suggested that the district should include only the metropolitan area of New York City believed that the territory attached to the New York Bank should be concentrated as much as possible. He advanced an individual reason for his opinion. He said that if the capitalization of the New York Reserve Bank were originally made unreasonably out of proportion to the other banks, and under the power conferred by the Act, the Federal Reserve Board should later decide to change the districts and reduce the size of the New York Bank, it might upset the layout and financial poise of the whole Federal Reserve system. It was even suggested that it was not necessary to have a Reserve bank in New York but that a branch bank might be located there.

In the course of the three days' hearings the Organization Committee listened to forty-eight witnesses. All but a very few of these testified in favor of a large Reserve bank in New York and emphasized the need for it. Most of the witnesses wished to see New England placed in the New York district. In support of the large bank idea the following points were advanced:

1. New York has been looked upon as the financial center of the United States from the beginning of the republic.
2. To create an institution which would command respect abroad. While the New York Bank would be coördinated with the other Reserve banks through the Federal Reserve Board, yet Europe will look to particular Reserve banks for certain purposes, for example, to the Chicago Reserve Bank in its grain business, the New Orleans Bank in the cotton business and to the New York Bank in its exchange and discount transactions.
3. To equip the New York Reserve Bank for dealing with the clearing house banks. A strong bank is needed in New York to overshadow the local New York banks in order to be in a position to loan member banks in time of emergency. Larger banks are not inclined to go to a small one for business. If the personal ambitions of member banks to overshadow are not curbed by the power and size and strength of the Reserve banks, many of the old diseases will be uncured.

4. The New York Bank should compare favorably in size with the largest national banks in New York City.

5. "There are two banks here now with a \$25,000,000 capital and I wouldn't want to see a smaller Federal Reserve Bank."

6. Acceptances should be created in New York and it is believed they will not be created in New York unless there is a great bank in New York City which will give stability and certainty of a market for all such paper at all times.

7. The New York Bank should be a large bank with at least 40 per cent of the banking resources of the system in order to develop an open discount market in the United States. It is not thought possible to establish any such market elsewhere at first. If the New York Bank were very strong, then discount or acceptance houses would become established and we would then have a market with standardized commercial paper like they have abroad. Parties would invest in commercial paper because there would be almost a certainty that it could be sold at any moment.

One of those who urged the inclusion of all territory north of the Potomac, including all of Pennsylvania, stated that the capital of the New York Bank on a 3 per cent basis would amount to \$25,575,000. Secretary McAdoo asked if this would not reduce the other seven or more banks to puny institutions. Whereupon he was answered: "Better have one strong bank and seven puny ones than to have eight puny ones."⁶ The president of one of the New York City banks, in urging that the New York Bank be made a large one, admitted this would mean that the others would be small but said that was unavoidable "as the country did not lend itself into eight districts." In estimating the size of the New York Bank most of the witnesses rested their calculations upon a 3 per cent basis as they felt that the remaining 3 per cent would be called only in an emergency and probably not in the immediate future. Secretary McAdoo, however, was inclined to believe that the Federal Reserve Board would call the second 3 per cent in connection with the original organization. Secretary McAdoo figured that on a 6 per cent basis, the aggregate capital of the eight or more banks would be \$106,000,000. If the New York district took in all the territory which some of the witnesses urged, the New York Reserve Bank would have 45 per cent

⁶ Charles A. Conant, Economist, The New York Times, Jan. 6, 1914, p. 19.

of this capital, leaving only \$55,000,000 or \$60,000,000 to be divided between the seven or more other Reserve banks.

New England's Claim for a Reserve Bank of Its Own

Reports of the hearings in New York were received with apprehension by interested parties in Boston. They had learned that the emphasis in New York was upon a preponderant bank and in order to have that it would be desirable to include New England. There was much opposition to this idea in New England so the hearings in Boston centered around the question of whether Boston should be attached to New York or have a Reserve bank of its own. In opening the hearings in Boston, which were held on January 9 and 10, Secretary McAdoo impressed upon the witnesses the serious purpose of the committee. He said: "I think there is an impression that only one bank will be located in each district. Now that is true so far as the headquarters banks are concerned, but it is not true in another aspect of the case. These banks are permitted to have branches, and through that machinery it is expected that these facilities will be placed at the disposal of all parts of the district, so that the banks in every part of the respective districts will be within easy reach either of the headquarters bank or some one of its branches. Now we quite understand the local pride which prompts the various cities to enter into friendly contest for the headquarters of these banks. At the same time, gentlemen, this is a broad and most important economic problem. It is not a political problem, it is an economic problem. This committee is not on a political expedition. We are not on a junket. We are here for business and we intend to deal with this proposition in a strictly business fashion."

Notwithstanding the Secretary's admonition against raising the question of pride, that factor was in evidence more than once during the Boston hearings. One witness said: "I have been a Boston merchant for forty years and have a pride, a New England pride, a Massachusetts pride, in Boston as a great financial and commercial center. I put it in two words, fair play. We think fair play would give us a

regional bank in Boston, and we resent unfair discrimination." Another said the people of New England desired their section to be regarded as a separate and homogeneous unit with a Federal Reserve bank of its own for historical and sentimental reasons. Nearly all of the witnesses, however, gave some economic reasons for their stand. The idea advanced in New York of a preponderant bank there was attacked with much vigor. Several points were made in opposition to the idea.

As far as creating respect abroad and being able to establish effective relations with the central banks were concerned, it was argued that it is feasible for a small country to borrow from a large one, but not a large country from a small one, and that the banking resources of the United States are greater than those of any European country. Also, that it is not necessary for the New York Bank to do any foreign exchange business and if it does not do any it is immaterial whether the Bank is large or small, because it can influence gold movements through affecting foreign exchange rates by changing the discount rate.⁷ Others argued that the strength of the system lay in the coördination of the Reserve banks through the Federal Reserve Board rather than in the size of any one bank; that it was not necessary to have the New York Reserve Bank larger than any of its member banks; and that to make the New York Reserve Bank a preponderant one would mean a reduction in the size and scope of operation of some of the others to a point which would make their portfolio undiversified and reduce their effectiveness.

The argument that the financial predominance of New York required a very large bank was parried in various ways. It was stated that while New York was subject to financial strain such as the calling of brokers' loans, the payment of commercial paper, and the withdrawal of bank balances, after the Federal Reserve system is established, New York would not be subject to so much strain because exchange on other cities, for example, Chicago, St. Louis, and Boston, would be just as good as exchange on New

⁷ O. M. W. Sprague, Harvard University.

York; also that commercial paper would not be payable in New York to such an extent as before, and that call loans would not be the most liquid assets a bank would hold and therefore banks would not seek to secure additional funds by calling brokers' loans.⁸

There was a strong feeling that Boston was entitled to a Reserve bank of its own for more positive reasons. Statistics were introduced to show that whereas New England comprised but 2 per cent of the area of the United States, it had 7 per cent of the population and 14 per cent of the "productive ability," that New England ranked first in savings per capita, had the lowest discount rates in the country for short-term maturities, and a regional bank in Boston could maintain a comparatively low rate of discount, that Boston was the third city in the United States and the fourth in bank deposits. It was pointed out that New England was the center of the cotton, woolen, and boot and shoe industries, producing more than half of the entire output of each industry in the country. Considerable emphasis was laid by several witnesses upon the particular character of these industries and how they were related to the problem.

It was stated that New York does not know anything about the credit requirements in the leather, shoe, and woolen industries and very little about the cotton industry; that the paper of these industries should be handled by people who have the technical knowledge of these industries and their related branches and are qualified to pass upon financial paper arising out of these lines of business, and that if this paper is handled by a Reserve bank in New York, "it will be less well known, less wisely handled by them with reference to the Reserve bank and with reference to the community." The paper arising out of the operations of these industries together with that offered in the towns, was purchased by bankers in New England towns and there grew up a local discount market in New England. It was argued that bankers in such towns as Salem, Lynn, and Portland did not know and would not know in the future names appearing on the acceptances and commercial paper in New York, while

⁸ *Idem.*

the names on the paper in Boston would be local and would command local capital. In this connection it was also argued that since familiarity with credit requirements in New England was desirable, that Boston should have a Reserve bank because six of the nine directors would be chosen by the member banks of the district, whereas, if Boston were made a branch of New York, the seven directors of the branch would be chosen by the directors of the New York Reserve Bank.

This question of control was also considered important from another angle when it was argued that the New York Bank would be controlled by New York interests; and that in time of need for currency, New England would want currency at the same time as New York; but that in case of a question as to who shall get it, New York will get it and not New England because New York has control of the Reserve Bank and not New England and New York is going to protect New York first. Therefore New England people wished a regional bank of their own in Boston, built up with their own resources and on which they could depend in case of trouble.

Previous to the establishment of the Federal Reserve system there had developed in several cities of the country a system of collecting checks on banks in contiguous territory. Such a system had developed in Boston and it was introduced to give force to the contention that Boston should have a Reserve bank of its own. Under that system the Boston Clearing House Association undertook to collect all checks on banks in New England, giving the time and labor free. If the bank remitted at par no charge was made, otherwise a charge was made corresponding to the charge made by the bank. It was argued that this check collection system covered all New England, bound it together and gave it an entity that was real and that if a Reserve bank should be established in Boston all of this practical experience could be drawn upon, taken over without change, and could be done better than another regional bank could do it.

The Size of the Boston District

The sentiment for a Reserve bank in Boston was very strong and widespread. Bankers associations, clearing house

associations, chambers of commerce, real estate, trade, and labor organizations in New England passed resolutions petitioning the selection of Boston and presented them to the Organization Committee. The difference of opinion at the Boston hearings turned largely upon the question of whether all of New England should be attached to the Boston Reserve Bank and if not all, how much should be attached to New York. A good share of the opinion held that New England was a unit and should be treated as a unit and that a regional bank in Boston should have as its territory the whole of New England and not nine-tenths or any other fraction of it. Some of the witnesses were inclined to consider the advisability of attaching outlying portions of New England, such as Vermont and the western half of Massachusetts, to the New York district.

Some banks in these parts of the country had been maintaining balances in Albany, Philadelphia, and New York because of the free collection of their checks and it was suggested in New York that to attach this territory to New York would be merely maintaining existing banking relationships. In answer to this it was stated that under the Federal Reserve system with its par collection that question is eliminated and it was argued that those banks would return to Boston where they were originally and to which they are naturally attached because of quicker service and returns. That part of New York west of Massachusetts and north of Albany it was also felt naturally belonged to Boston. One witness went so far as to urge that not only the entire area of New England be allocated to a Reserve bank in Boston but that most of New York State be assigned to Boston. He advocated dividing New York into two parts with Wall Street as the dividing line and putting the whole of New York State north of Wall Street with the Boston district. Bankers who carried accounts in New York, Albany, Philadelphia, and Chicago for collection purposes testified that these were artificial relations and that under the Federal Reserve system they would prefer to be connected with a regional bank in Boston. They felt that since domestic collection and exchange charges would be elim-

inated, Boston exchange would be just as good as New York exchange so no attention needed to be paid to the existing methods of payments between sections of the country.

There was still more inclination to allow New Haven, Hartford, and western Connecticut to be allocated to New York. Hartford as represented by the Hartford Clearing House and the Business Men's Association preferred to be in the New York district. It was stated that most of Hartford exchange was in New York banks, only 15 per cent being in Boston, and that business transactions were largely carried on with New York. In answer to this it was argued that if a branch of the Boston Bank were established at Hartford all the banks in Connecticut would be as well served if connected with Boston as they would be if connected with New York. On cross examination one witness admitted that the clearing and collection features of the Federal Reserve Act would have a very material effect in relieving the situation so far as exchange is concerned. Another witness argued that under the new clearing and collection system, banks in this part of Connecticut would be as well taken care of by effecting relations with Boston banks as with New York banks, but if they so desired the then existing ordinary correspondent relations with the New York banks would not need to be changed. It would be only in the matter of rediscounting that they would be served by the Boston Bank.

A still smaller portion of Connecticut, the New York suburban zone of western Connecticut, was considered. The point of view of those who favored a 100 per cent New England district for the Boston Bank may be represented by the following: "There must be great convenience in observing state lines as far as possible, and it seems to me that the inconvenience of western Connecticut is so little, that it will be so little disturbed by hitching them on to the regional bank here in Boston, that it had better be done. It is only a matter of a little inconvenience and a little sentiment. I do not think it is a matter of moment at all."⁹

In the course of the Boston hearings two of the witnesses

⁹ William A. Gaston, president of the National Shawmut Bank, Boston.

introduced plans for the districting which required that the country be divided upon a basis of geographical lines, the meridians of longitude and the parallels of latitude. It was argued that the state boundary lines were political and hence of an arbitrary nature and not suitable for standardizing statistical, financial, or any other kind of information which is based upon the laws of science. The lines were to be chosen at such a distance apart as would result in a division of the country into about four hundred blocks and then statistical information pertaining to the problem in hand was to be secured for each block. The hearings were concluded after the committee had listened to fifty witnesses.

The Organization Committee's Methods and Principles of Districting

During the week of January 12, 1914, the Reserve Bank Organization Committee sat in Washington, D. C., to hear the claims for Philadelphia, Pittsburgh, Baltimore, Wheeling, Richmond, and Washington. The Pittsburgh delegation desired that Pittsburgh be made a Reserve bank city, but failing that, they wished to be in a district with New York as the Reserve bank city rather than Philadelphia. The Philadelphia delegation urged that a Reserve bank be located in their city and strongly opposed a great bank in New York. They were inclined to Secretary McAdoo's view that foreigners would look to the entire system for evidence of strength rather than to any one Reserve bank. The hearings on the rival claims of the eastern cities were concluded in Washington, D. C., on January 16. Following these, hearings were held in thirteen cities scattered throughout the country beginning at Chicago and ending at Cleveland. On this circle tour the Committee had an office on wheels, a steel railway car especially equipped for the purpose. In it they lived most of the time and went over testimony and correspondence received from Washington, D. C., regarding the districting problem. In the meantime the Committee's expert had received the testimony and documents and prepared a scientific analysis of the districting problem.¹⁰

¹⁰ Secretary McAdoo had appointed Dr. Willis to prepare individually a

He submitted a report to Secretary McAdoo's Committee in which the following principles were set forth: ¹¹

The fundamental principles of a positive nature upon which the process of districting should be carried out may now be laid down.

(a) The Act calls for not less than eight nor more than twelve districts; it leaves the choice of the number within these limits entirely open and to be decided without prejudice.

(b) The plain intent of the framers of the act was to establish a number of different and independent institutions, each sufficiently strong to care for itself without the necessity in normal times of depending upon any other.

(c) The institutions to be created should, therefore, be reasonably similar to one another in size, without attempting to bring about any artificial similarity, and should be located at such points as will most nearly convenience the business of the country.

(d) The creation of any one large bank should be avoided, meaning by large bank, a bank so preponderating in importance as to make it ipso facto the most conspicuous and by far the strongest element in the system; while at the same time it should be sought to avoid the creation of two distinct classes of banks, one consisting of large, powerful institutions, the other consisting of smaller and weaker institutions likely to become dependent upon the neighboring and stronger banks.

(e) While the law requires that a minimum capital of \$4,000,000 shall be present in each and every district and while this requirement must be observed, there is no harm in approaching closely to it or even in going below this limit so far as the banks are concerned, making up the deficiency by private or government subscription, if it be true that within a reasonably near future the district will probably advance in wealth and capital so as to make the establishment of such a bank desirable.

(f) Special study should be given both in establishing the districts and in establishing the point in each district where the headquarters bank is to be situated, to the facilities and speed of transportation both between such point and those at which other

districting plan. A total of about 5,000 pages of stenographic reports of the hearings were filed. These together with documents and briefs were examined by Dr. Willis and an analysis of the districting problem was prepared by him which was used as a basis for the Organization Committee's report. This analysis is published in: *The Report of the Preliminary Committee on Organization to the Reserve Bank Organization Committee*, pp. 6-17: Published June 1, 1914, New York, for private circulation (Confidential, No. 243). It may also be found in Willis, *The Federal Reserve System*, pp. 566-578.

¹¹ Report to the Reserve Bank Organization Committee by the Preliminary Committee on Organization, p. 12.

headquarters banks are located, and between such headquarters point and the outlying portions of the district itself.

When the Reserve Bank Organization Committee returned to Washington the middle of February it began the preparation of its report to Congress. On April 2, 1914, the Committee announced its decision.¹² It selected twelve cities, the maximum number possible under the Federal Reserve Act for Federal Reserve banks: Boston, New York, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, St. Louis, Minneapolis, Kansas City, Dallas, and San Francisco. The Committee stated that every reasonable opportunity had been afforded applicant cities to furnish evidence to support their claims as locations for Federal Reserve banks. Representatives of more than two hundred cities were heard and of these thirty-seven cities applied for a Federal Reserve bank. The majority of the Organization Committee including its chairman, the Secretary of the Treasury, and the Secretary of Agriculture were present at all hearings.

In addition many independent investigations were made through the Treasury department and the preference of each bank as to the location of the Federal Reserve bank with which it desired to be connected was ascertained by an independent card ballot addressed to each of the 7,475 national banks throughout the country which had formally assented to the provisions of the Federal Reserve Act.¹³ The Committee endeavored to follow state lines as closely as practicable and deviated from them only wherever it was considered convenient and advantageous for the districts concerned.¹⁴ Many factors were considered by the Committee in the selection of the cities and the district lines, prominent among which were:¹⁵

First. The ability of the member banks within the district to provide the minimum capital of \$4,000,000 required for the

¹² Decision of the Reserve Bank Organization Committee Determining the Federal Reserve Districts and the Location of Federal Reserve Banks. Government Printing Office, 1914.

¹³ *Ibid.*, p. 3.

¹⁴ *Ibid.*, p. 4.

¹⁵ *Idem.*

Federal Reserve bank, on the basis of 6 per cent of the capital stock and surplus of member banks within the district.

Second. The mercantile, industrial, and financial connections existing in each district and the relations between the various portions of the district and the city selected for the location of the Federal Reserve bank.

Third. The probable ability of the Federal Reserve bank in each district, after organization and after the provisions of the Federal Reserve Act shall have gone into effect, to meet the legitimate demands of business, whether normal or abnormal, in accordance with the spirit and provisions of the Federal Reserve Act.

Fourth. The fair and equitable division of the available capital for the Federal Reserve banks among the districts created.

Fifth. The general geographical situation of the district, transportation lines, and the facilities for speedy communication between the Federal Reserve bank and all portions of the district.

Sixth. The population, area and prevalent business activities of the district, whether agricultural, manufacturing, mining or commercial, its record of growth and development in the past, and its prospects for the future.

The Districting Decision

The district allocated to the Reserve Bank in New York City was designated the Second Federal Reserve District and its boundary lines were made coterminous with those of the state of New York. The land area of this district was 47,654 square miles and the population was 9,113,614.¹⁶ The New York district as originally formed was the second smallest in area and the second largest in population. An important factor responsible for the small geographical size of the district was the desire to avoid the creation of a relatively preponderant Federal Reserve bank in New York City. Another factor was the proximity of the stock market. The Committee wished to reduce the number of banks having direct contact with the Reserve bank operating in the location of the securities market.

The contrast between geographical conditions in the United States and abroad which in part warranted the regional central bank plan, so fiercely opposed, is shown by the following. The territory of continental United States is an area greater than all of Europe, exclusive of Russia,

¹⁶ United States Census, 1910.

comprising 2,973,890 square miles as against 1,936,320 square miles for the latter. The three countries of Europe especially interesting on account of their established central banks are dwarfs compared with the United States. They are the United Kingdom with 121,391 square miles, France with 207,220 square miles, and Germany with 209,000 square miles. In the Chicago Federal Reserve district alone there were over 12,000,000 people, a number greater than the combined population of Norway, Sweden, and Switzerland. In the San Francisco district alone there could be put all of Great Britain, France, Italy, and Germany and there would still be left an area larger than all of New England excepting the state of Maine.¹⁷

The analogy is not exactly comparable because of the conflict of national entities abroad within a similar extensive area; while in the United States, notwithstanding the extensive area, there is a unity of interests in the various sections which go to make up our national life, and an economic interdependence among them. But, in addition to the immense distances, as regards economic development and interests and relative risk attaching to the commitment of capital, there were, when the Federal Reserve system was established, marked differences as between widely separated parts of the United States.

Readjustment of District Lines

Following the announcement of the Organization Committee's decision dissatisfaction was voiced by representatives of several cities and a number of banks over the country.¹⁸ While economic considerations for the most part governed Secretary McAdoo's Committee, unfortunately political pressure at certain points brought about some serious errors in districting. The Committee chose the Reserve bank cities first and then tried to fit a district around them instead of the reverse. While in the case of

¹⁷ Address of Charles S. Hamlin, governor of the Federal Reserve Board, before the New York State Bankers Association, Saratoga Springs, N. Y., June 25, 1915.

¹⁸ Annual Report of the Federal Reserve Board for 1914, p. 5.

three or four cities, which were obviously proper locations, this procedure was all right, when applied to the whole country it brought some unsatisfactory results.¹⁹

So far as the New York district was concerned the Organization Committee erred in not allocating northern New Jersey and part of Connecticut to the New York Reserve Bank. The Banking and Currency Committee of the New Jersey Bankers Association had polled the banks in New Jersey to determine of which Reserve bank each wished to be a member in the event that Reserve banks were established at both New York and Philadelphia. The result was that practically all of the banks north of Mercer and Ocean Counties desired to be included in the New York district and the balance in the Philadelphia district.²⁰ This was pointed out at the hearings in New York in January, 1914. The banks in the northern part of New Jersey, with few exceptions, have no direct rail communication with Philadelphia and their banking and trade channels all run to New York City. Yet in spite of these facts the Organization Committee assigned the banks in northern New Jersey to the Philadelphia Reserve Bank.

The New Jersey bankers' Banking and Currency Committee quickly endeavored to have the assignment changed but was told that under the law once the decision of the Reserve Bank Organization Committee had been rendered it was final and recourse would have to be to the Federal Reserve Board. The Federal Reserve Act provided that "the districts thus created may be readjusted and new districts may from time to time be created by the Federal Reserve Board, not to exceed twelve in all" and that the decision of the Organization Committee "shall not be subject to review except by the Federal Reserve Board when organized." The New Jersey banks chafed under this delay

¹⁹ Concerning some problems of districting in other parts of the country and the selection of cities see Decision of the Reserve Bank Organization Committee Determining the Federal Reserve Districts and the Location of Federal Reserve Banks, Government Printing Office, 1914. This may also be found in the Report of the Comptroller of the Currency, Dec. 7, 1914, Vol. I, pp. 135-153; Willis, *The Federal Reserve System*, chapter XXIV.

²⁰ *The Financial Age*, May 16, 1914, p. 827.

and some of the larger national banks made advances to secure state charters. The cashier of the First National Bank of Jersey City is reported to have said: "I asked Commissioner LaMonte if he would put anything in our way if we decided that placing us in the Philadelphia district had hurt banking in Jersey City and we decided we would relinquish our national charter and take out a state charter. He said there would be no trouble.²¹ . . ." A vice president of the Hudson County National Bank of Jersey City is reported to have said: "We have not actually applied for a state charter, but there is a strong possibility of our doing so, unless the Federal Reserve Board when it organizes heeds our appeal and places us in the New York district. The annexing of our banks to the Philadelphia district will prove a matter of great inconvenience. I do not believe we would experience any great difficulty in securing a state charter."²²

The members of the Federal Reserve Board took their oath of office on August 10, 1914, but chose to postpone consideration of the matter of readjusting district lines until the Federal Reserve banks were established. It was considered best not to delay the opening of the Reserve banks and the later strained conditions in finance and business confirmed the soundness of the Board's judgment.²³ On September 26, 1914, the Banking and Currency Committee of the New Jersey Bankers Association in behalf of the member banks in northern New Jersey filed a petition. It was signed by 123 out of the 132 national banks in the ten northern counties and prayed that the territory in which they were located be transferred from District No. 3, the Philadelphia district, to District No. 2, the New York district. This petition was supported by a brief stating the reasons why they wished the transfer to be made.²⁴ The

²¹ Ibid., p. 856.

²² Idem.

²³ Annual Report of the Federal Reserve Board, 1914, p. 5.

²⁴ The following is a part of the brief: "The volume of checks drawn on any particular city which are received on deposit by a bank show very accurately the amount of business which is done by the community in which the bank is located with the community on which the checks are drawn. Taking this method as a basis, we find that the commercial business of northern New Jersey with New York is fully ten times as much as the commercial business

Reserve banks were opened in November and when the pressure of organizing the system was over attention was given to the question of redistricting. Hearings on the petition were held in Washington on January 20, 1915, before the Federal Reserve Board. In technical opposition to the New Jersey banks appeared the governor of the Federal Reserve Bank of Philadelphia and the counsel of that bank. On May 4, 1915, the Federal Reserve Board of that section with Philadelphia, and throughout that section of the state the ties, both commercial, financial, and social are almost entirely with New York City. The industrial enterprises of northern New Jersey, especially those located in the large cities of Hudson, Passaic, Essex, Union and Middlesex counties, do a very much greater business with New York than with Philadelphia. Most of these concerns have offices in New York City, while but few of them have offices in Philadelphia. We append tables showing the population and industrial importance of northern New Jersey.

"We are advised by the banks of northern New Jersey that of the checks which they receive on deposit drawn on the cities of New York and Philadelphia from 85 per cent to almost 100 per cent are drawn on New York City, and on account of the large volume and amount of these checks payable in New York City it is essential that they be sent directly there in order to insure prompt presentation and prompt notice in case of non-payment. It is impracticable to send these checks to New York by way of the Philadelphia Reserve Bank. This very same question will arise in connection with the very heavy volume of checks payable in northern New Jersey which are received on deposit by the New York City banks.

"An analysis of figures which were received by the Comptroller of the Currency from banks of northern New Jersey during the month of June last will demonstrate the close relationship existing between New York City and northern New Jersey, and will show that this relationship is much more active and close than that existing between northern New Jersey and Philadelphia. In taking these figures into consideration it must be borne in mind that the Comptroller's figures separate New York City from New York State, but do not separate Philadelphia from the State of Pennsylvania.

"We give below figures covering the month of June furnished by five representative institutions in Newark, New Jersey, showing the volume of checks on Newark received from New York City and from Philadelphia, and the currency shipments between Newark and New York, there being none with Philadelphia:

On local banks, received from New York City	\$19,096,489
On local banks, received from Philadelphia	2,351,506
Currency shipments to and from New York City	2,034,000

"A considerable number of the banks in northern New Jersey at certain times in the year purchase commercial paper. This is all purchased through New York brokers, and is usually passed upon by New York banks before being purchased.

"The relations existing between the banking institutions of northern New Jersey and the banks of New York City have always been most intimate, and

approved the petition and passed a resolution transferring the following counties in northern New Jersey from District No. 3 to District No. 2: Bergen, Essex, Hudson, Hunterdon, Middlesex, Monmouth, Morris, Passaic, Somerset, Sussex, Union, and Warren.²⁵ This readjustment became effective July 1, 1915.²⁶

In western Connecticut a similar disaffection developed though a little later than in the case of the New Jersey banks. On May 10, 1915, a group of fifty-two national banks in Connecticut petitioned the Federal Reserve Board that all that part of Connecticut west of the Connecticut River be transferred from District No. 1, the Boston district, to the New York district. In support of the change the banks said: "Ever since the beginning of the national banking system these banks have always transacted the majority of their banking business with New York, which is their natural center and to which mostly all business of a financial nature as well as a commercial nature automatically flows. To try, therefore, to change this natural flow and trend to an artificial and forced point seems, if we may be allowed to use the simile, like trying to make water flow up hill. If left in the Boston district these banks can never derive the benefits from the system which they ought to, because it will be unnatural, inconvenient, and burdensome." The banks contended that ten times as much business was done with New York as with Boston.²⁷ Further efforts to effect this redistricting in Connecticut occurred in February, 1916, when a committee representing banks located in Hartford, Waterbury, New Haven, and Bridgeport (all in western Connecticut) appeared before the Federal Reserve Board and petitioned that they be transferred from the Boston to the New York district. They presented statistics showing that

the transactions between that section of New Jersey and New York City are carried on in a very large degree through personal contact, resulting in mutual advantage. On account of this close relationship no artificial barriers should be erected, and if erected, will prove injurious to the banks of northern New Jersey." *The Financial Age*, Oct. 10, 1914, p. 608.

²⁵ Annual Report of the Federal Reserve Board, 1915, p. 114.

²⁶ *Ibid.*, p. 28.

²⁷ *The Commercial and Financial Chronicle*, July 31, 1915, p. 335.

more of the business of the banks in western Connecticut was transacted with New York than with Boston and argued that trouble resulted from the necessity of being joined to the Boston Reserve Bank.

Counsel for the Boston Reserve Bank opposed the change sought and argued that it was essential that all available sources of income be deflected to Boston and away from New York, if it was the desire of the Board to prevent centralization of capital in one Reserve bank city.²⁸ Upon consideration of the petition and the answer of the Federal Reserve Bank of Boston the Federal Reserve Board stated, "it appears to the Federal Reserve Board that the convenience and customary course of business and the best interests of the Federal Reserve system will be served by a readjustment of the geographical limits of Districts No. 1 and 2," and on February 29 voted to transfer the County of Fairfield in Connecticut to District No. 2.²⁹ The transfer was made effective April 1, 1916.³⁰ The petition of the Connecticut banks in so far as it related to that part of Connecticut west of the Connecticut River outside of Fairfield County was not granted and the banks in the cities mentioned above are members of the Boston Reserve Bank.

Since the addition of Fairfield County, Connecticut, the boundaries of the New York Federal Reserve district have remained unchanged. A map of the district is shown on page 60. This district at the present time constitutes an area of 51,890 square miles, distributed as follows: ³¹

The entire state of New York	47,654 square miles
Twelve counties in New Jersey	3,605 square miles
Fairfield County in Connecticut	631 square miles

The estimated population of the district is 16,622,000.³² As at the time of its original formation the district is still the second smallest in area and the second largest in population, the Philadelphia district being the smallest in area while the Chicago district has the largest population.

²⁸ The Commercial and Financial Chronicle, Feb. 19, 1916, p. 656.

²⁹ Annual Report of the Federal Reserve Board, 1916, p. 124.

³⁰ Ibid., p. 126.

³¹ Annual Report of the Federal Reserve Board, 1931, p. 236.

³² Annual Report of the Federal Reserve Board, 1933, p. 383.

Effort to Reduce the Number of Federal Reserve Districts

While some of the original errors of judgment on the part of the Organization Committee were thus later rectified by the Federal Reserve Board, an effort to bring about a major change in the districting plan of the Federal Reserve system failed of fruition. This major change involved the elimination of several of the Federal Reserve districts and, of

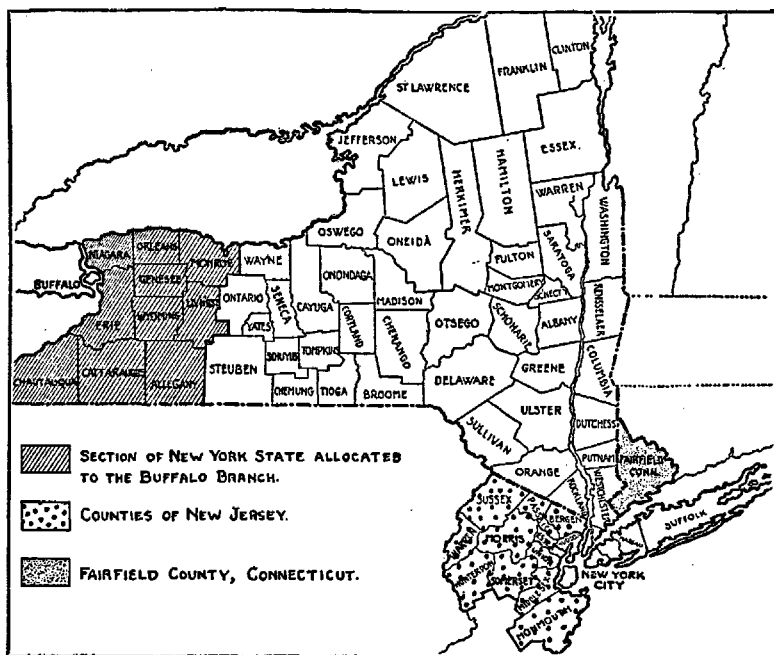


FIG. 1.—The Second Federal Reserve District

course, their Federal Reserve banks, in the South and West.³³ This was an effort initiated by the New York member of the Federal Reserve Board who had formerly opposed the regional Reserve bank plan of the Federal Reserve Act when it was under discussion by Congress.

It will be recalled that the New York bankers especially desired not to disturb the old correspondent banking rela-

³³ Consult Willis, *The Federal Reserve System*, chapter XXIV; W. P. G. Harding, *The Formative Period of the Federal Reserve System*, pp. 34-38.

tionships of the national banking system. The alleged authority for the change in the organization of the system was based upon that part of section 2 of the Federal Reserve Act which reads: "The districts thus created may be readjusted and new districts may from time to time be created by the Federal Reserve Board, not to exceed twelve in all." The Federal Reserve Board had been organized but a few weeks when certain members of that body began to promote a reduction in the number of Federal Reserve districts. The discussion of this change increased to such an extent that the Board finally resolved to appoint a special committee of its members to consider the matter. The question was referred to counsel. The Board's general counsel held that the section of the Federal Reserve Act referred to did not give the Board authority to reduce the number of Federal Reserve districts.³⁴ A special counsel employed by the Board rendered a contrary decision.³⁵ Finally, the Attorney-General of the United States ruled that the Board had no power to reduce the number of Federal Reserve districts from the number of twelve³⁶ which was established by the Reserve Bank Organization Committee nor to change the present location of any Federal Reserve bank.³⁷ The argument of the Attorney-General was to this effect: that the Federal Reserve Board had no power under the Federal Reserve Act to change any decisions of the Reserve Bank Organization Committee unless the power to change a certain decision was specifically conferred in the Act; that the power to "readjust" districts created and to create new ones did not mean the power to reduce; and that inasmuch as the power to abolish certain districts or banks was not affirmatively conferred, the Federal Reserve Board had not the power to reduce the number of Federal Reserve districts nor change the location of any of the Federal Reserve banks. The Attorney-General's decision settled the move to eliminate some of the Federal Reserve districts,

³⁴ Federal Reserve Bulletin, Vol. II, 1916, p. 20.

³⁵ *Ibid.*, p. 25.

³⁶ Federal Reserve Bulletin, Vol. I, 1915, p. 396.

³⁷ Federal Reserve Bulletin, Vol. II, 1916, p. 207.

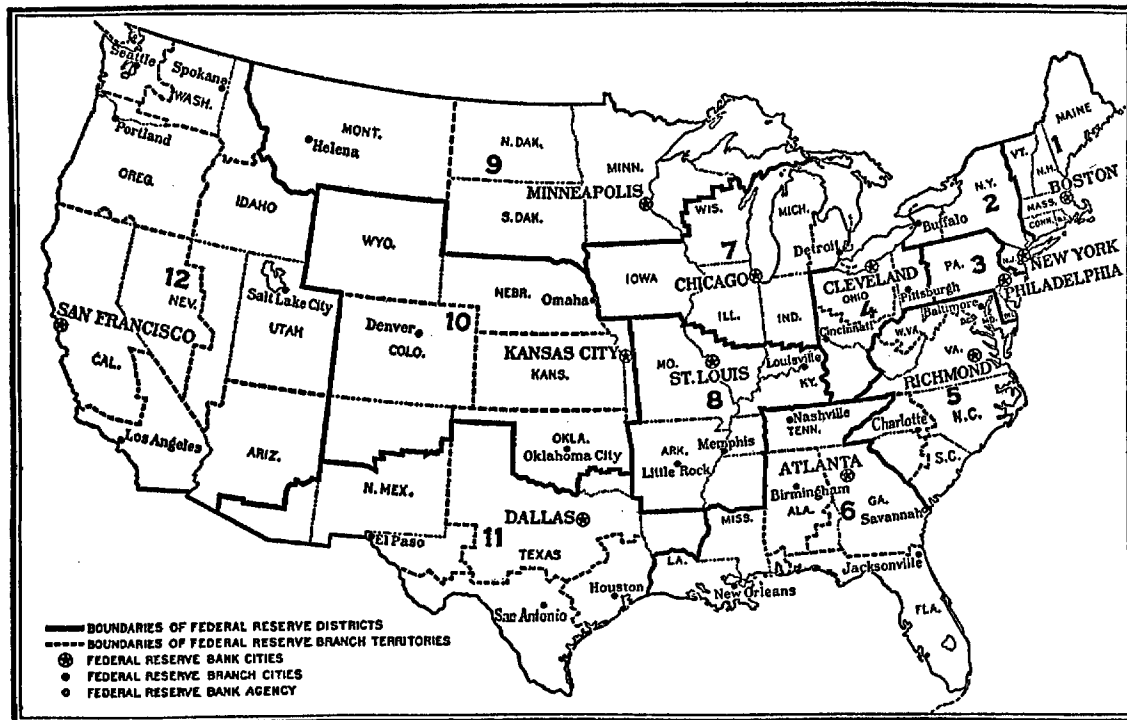


FIG. 2.—The Federal Reserve Districts, Bank and Branch Cities

no recurrence of any such effort having been made. Thus, with the few minor changes in district lines, the pattern of the Federal Reserve system assumed its present form about the middle of 1916. The accompanying map shows the twelve Federal Reserve districts and the location of the Federal Reserve banks and their branches.

CHAPTER IV

ESTABLISHMENT OF THE FEDERAL RESERVE BANK OF NEW YORK

Incorporation

New York City was designated as the location of a Federal Reserve Bank by the Reserve Bank Organization Committee on April 2, 1914. The Federal Reserve Act provided that national banks must join the Federal Reserve system or forfeit their national bank charters. The establishment of the Reserve Bank was uncertain. It was an open question as to whether the large national banks in New York City would join the Federal Reserve or forfeit their national charters.¹ The Federal Reserve Act stated that in case the amount of the subscriptions to the capital stock of the Reserve Bank was insufficient, stock would be offered to the public at par. But the offering of stock for public subscription proved to be unnecessary. There were 477 national banks in the New York or Second Federal Reserve District and every one of them accepted the provisions of the Federal Reserve Act and announced its intention to subscribe to the capital stock of the Federal Reserve Bank of New York.

When the minimum amount of capital stock prescribed by the Federal Reserve Act for the organization of any Federal Reserve bank was subscribed, the Reserve Bank Organization Committee designated five banks and notified them on May 11, 1914, to execute the organization certificate of the Reserve Bank. The following banks were selected to effect the incorporation of the New York Reserve Bank: National Commercial Bank, Albany; First National Bank, Syracuse; Marine National Bank, Buffalo; National Park Bank, New York City; Irving National Bank, New

¹ The Commercial and Financial Chronicle, Dec. 27, 1913, p. 1854.

York City. Orders were dispatched to these banks asking that a special meeting be called at once for the purpose of passing a resolution sent to them authorizing its officers to sign the organization certificate.² Clothed with such authority representatives of the banks named met at the office of the president of the New York Clearing House Association in New York City who held the certificate of incorporation as the agent of the Reserve Bank Organization Committee. They signed the certificate which was filed with the Comptroller of the Currency on May 18, 1914. On this date the Bank was incorporated and it marks the birth of the Federal Reserve Bank of New York,³ possessed of the powers conferred by law except that it could not transact "any business other than such as was incidental and necessarily preliminary to its organization, until formally authorized by the Comptroller to begin the business of banking."⁴

Election of Directors

The next step in the establishment of the Reserve Bank was the election of directors. The election procedure was laid down in the Federal Reserve Act and it devolved upon the Organization Committee to initiate and supervise the election. This Committee classified the member banks of the district into three general groups, each group containing approximately one-third of the aggregate number of the member banks of the district, and consisting of banks of similar capitalization. Group No. 1 contained banks having the largest capitalization, Group No. 2, banks of the next largest capitalization and Group No. 3 was composed of banks having the smallest capitalization. Of the nine directors of the Reserve Bank the member banks were to elect six. Three of these, called Class A directors, were to be representative of the stockholding banks and three, called Class B directors, were at the time of their election to be "actively engaged in commerce, agriculture, or some other industrial pursuit." The banks in each group were to elect

² The Financial Age, May 16, 1914, p. 863.

³ Annual Report of the Federal Reserve Bank of New York, 1915, p. 7.

⁴ Report of the Comptroller of the Currency, Dec. 7, 1914, Vol. I, p. 154.

one Class A director and one Class B director. To effect this result each of the member banks was required to elect a district reserve elector actually to cast the vote of his bank. The purpose of electing district reserve electors was "to obviate the necessity of convening the boards of the various member banks in order to vote on the nominees."⁵

When the Reserve Bank Organization Committee was effecting the incorporation of the Reserve Bank, the Comptroller of the Currency in a message to the member banks expressed the hope that the Organization Committee would receive nominations for Class A and Class B directors and the names of the district electors so that a vote could be taken early in June. The Organization Committee made every effort to expedite the election so that the board of directors of the Reserve Bank could be organized in ample time to elect officers, select employees and banking quarters, and place the banks in actual operation by August 1.⁶ Developments occurred, however, which prevented such an early opening of the Reserve Bank. The selection of the Bank's directors became involved in a heated controversy.

Under date of May 6, 1914, the Organization Committee sent a circular letter to all member banks relative to the steps to be taken in electing the directors together with forms upon which each member bank was to report to the Committee the name of its elector and the names of its nominees for Class A and Class B directors.⁷ The New York City banks, however, were unwilling that this election should proceed without effecting some control over the selection of that body of men who would direct the Federal Reserve Bank of New York. Accordingly a circular letter was sent by A. H. Wiggin, president of the Chase National Bank and chairman of the New York Clearing House Association, to each of the member banks in the Second Federal Reserve District. It invited their representatives to a separate conference for each group at the New York Clearing House to

⁵ Annual Report of the Federal Reserve Board, 1914, p. 66.

⁶ The Financial Age, May 16, 1914, p. 863.

⁷ Reserve Bank Organization Committee Circular 2, Annual Report of the Federal Reserve Board, 1914, p. 65.

consider the matter of nominations.⁸ The plan was to frame a "slate" at these conferences for directors of Classes A and B.⁹ It was so arranged that these group conferences were not to be held at the same time but were to meet at different times, Group 1 meeting first, then Group 2 followed by Group 3. The representatives of the largest banks, those in Group 1, met on Tuesday, May 19, at the New York Clearing House. At this meeting, A. Barton Hepburn of the Chase National Bank of New York City was elected chairman and William Woodward of the Hanover National Bank of New York City offered the following resolution which was adopted:¹⁰

"Resolved, that a committee of eight be appointed to recommend to the member banks names of suitable candidates for directors of Classes A and B of the New York Federal Reserve Bank, and that said committee be asked to meet with similar committees from Groups 2 and 3, if they be appointed; and further

"Resolved, that this group request Groups 2 and 3 to respectively appoint a similar committee, to meet with the committee from Group 1, so that intelligent and beneficial discussion may be had on this subject."

The representatives of banks in Group 2 met on Friday

⁸ Mr. Wiggin's letter to the banks of Group 2 follows: (The letters to Groups 1 and 3 were similar.)

"Gentlemen:

"The organization of the Federal Reserve Bank of this district is nearly completed so far as the Government is concerned, and presently the individual banks will be called upon to perform the part devolved upon them by statute, the election of a director representing the banking interests and also a director representing the commercial, agricultural or other industrial interests of the district.

"In order that there may be intelligent and concerted action, it is deemed desirable that a preliminary conference be held.

"We suggest a meeting of the members of each group of this Federal Reserve district in order that each and every bank may be given a voice in the proceedings and harmony and unity of action be secured. We are arranging for a meeting of the members of Group 1 on May 19 and for Groups 2 and 3 on May 22. We invite you to attend a meeting of Group 2 of this Federal Reserve district at the Clearing House in this city on Friday, May 22, at 11 A. M., for the purpose of a general discussion, interchange of views and the adoption of a proper course of procedure. We very much hope that some one representing your good institution will be present on this occasion." The Financial Age, May 16, 1914, p. 843.

⁹ Idem.

¹⁰ The Financial Age, May 23, 1914, p. 883.

morning, May 22. At this meeting which was presided over by Robert H. Treman, president of the Tompkins County National Bank of Ithaca and president of the New York State Bankers Association, Group 2 passed a resolution similar to the above.¹¹ The proceedings at both of these meetings were harmonious. Everything apparently went according to schedule and the committees provided for by the resolutions were appointed. Group 3, composed of banks having a capital and surplus of \$70,000 or less, had its meeting also on Friday but in the afternoon. Its session was prolonged, unharmonious, and at times took on the semblance of open revolt.¹² The meeting was opened by A. H. Wiggin, president of one of the largest banks in Group 1, who, as chairman of the New York Clearing House Association, had invited the bankers to the conference.

Robert H. Treman who was chairman of the Group 2 meeting in the morning was also put up for chairman of this Group 3 meeting. His sponsors finally succeeded in electing him chairman of the group, after taking three ballots, by a vote of 21 to 12. His election, however, evoked bitter opposition because he was not a member of Group 3, but belonged to Group 2 and had been elected chairman of that group at the morning session. Finally, after more than an hour's wrangling, Mr. Treman declined to serve as chairman and the group elected G. E. Merrill, cashier of the First National Bank of East Aurora, chairman. A Group 3 committee was then appointed to meet with the other group committees the following Tuesday.¹³ The joint meeting of the three group committees on May 26, resulted, after several hours of discussion in the unofficial nomination of some candidates for directors of the Reserve Bank. The candidates were nominated unanimously by the individual committees and then approved unanimously at the joint meeting. Groups 1 and 2 each nominated a candidate for Class A, and two candidates for Class B. Group 3 nominated one candidate for Class A but no candidate for Class B directors. At the time of the joint meeting it was understood that the Group 3 nominating committee would hold

¹¹ *Idem*.¹² *Idem*.¹³ *Idem*.

another meeting shortly thereafter to nominate two business men for that class of directors.¹⁴ According to the statute a bank's nomination for a Class A director did not need to be confined to a banker whose bank was classed in the same group. But once the nominations were officially made in the manner prescribed by law, a bank could vote only on the candidates nominated by the banks in the group to which it belonged.¹⁵

The purpose of this provision of the Federal Reserve Act was to make the Class A and Class B directors representative of various groups of banks and their customers and allow the smaller banks a better chance to have a voice in the management of the Reserve Bank. The series of bankers' caucuses initiated by the New York Clearing House banks resulted in the unofficial nomination for Class A directors of candidates all of whom were connected with Group 1, the largest banks.

The Group 3 nominating committee held another meeting, as planned, in Albany on June 3, to nominate two business men for Class B directors. A spirited contest took place at this meeting. Nearly two score of the bankers present declined to accept the nominees of the regular nominating committee for Group 3 at the New York City Conference.¹⁶ This group, called "insurgents," after having been ignored by the "regulars," subsequently held a meeting of their own and adopted the following resolution:

"Resolved, that this meeting recommend that a member for Class A and Class B directors of Group 3, regional reserve bank of New York, be a man representative of Group 3 and an officer of a Group 3 bank or associated with the interests of a Group 3 bank in a financial and business way."

In accordance with this resolution they then nominated a candidate for Class A director and a candidate for Class B director.¹⁷

Similar dissension arose among the Group 2 bankers. A

¹⁴ The Financial Age, May 30, 1914, p. 921.

¹⁵ Reserve Bank Organization Committee, Circular No. 2, May 6, 1914.

¹⁶ The Financial Age, June 6, 1914, p. 963.

¹⁷ Idem.

number of these met at Utica on June 5 and nominated one candidate for Class A director and one for Class B director. This insurgent group also passed unanimously a resolution favoring the selection of directors from Group 2 banks and interests, and urging all the member banks of the group not represented at the meeting to stand by this proposition.¹⁸ The so-called "insurgents" in Groups 2 and 3, while recognizing that their banks could legally nominate men affiliated with Group 1 banks to serve as directors of the Reserve Bank, held that Group 1 members could not satisfactorily represent the interests of banks in Groups 2 and 3 and decried the "Wall Street domination" which had inspired the first "regular" nominating conferences in New York City. Regarding the insurgent movement, the point of view of the New York City bankers was expressed by one of them who said: "If you had the job of selecting a captain for the Aquitania or the Vaterland, you would not pick out a canal boat skipper."¹⁹

During the month of June the contest for nominations waxed hot. The chairman of the original nominating committees of each group sent a joint letter to each member bank in the district urging the election of the "regular" nominees for the board of directors, in opposition to the recommendations of the "insurgents." On June 25 the Reserve Bank Organization Committee announced the names of the candidates for directors which had been nominated by the banks in the New York district.²⁰ There were fifty candidates, which evidenced the extent of the disapproval of the efforts of the largest banks to "put through" candidates of their selection. On July 7 the member banks received from the Committee the ballots on which they voted. But balloting proceeded slowly and as there were close contests for some positions the complete list of directors of the Reserve Bank was not known until the first part of August. Though the large banks were more successful in the election

¹⁸ *Idem*.

¹⁹ *The Financial Age*, June 13, 1914, p. 998.

²⁰ *The Financial Age*, June 27, 1914, p. 1119. For an account of the contest for nominations and the names of all the nominees, see *The New York Times*, July 8, 1914, p. 6.

the work of the "insurgents" bore fruit for them. Of the six directors elected by the banks, four were those recommended by the original New York City conference nominating committees and two were so-called "insurgent" nominees who were elected Class B directors representing business interests.

Appointment of Class C Directors

With the election of the Class A and Class B directors by the member banks, the appointment by the Federal Reserve Board of three Class C directors representing the Government remained to complete the board of directors of the new bank before it could begin active operations.²¹ One of the first tasks of the Federal Reserve Board, which was organized on August 10, was to select these directors, one of whom was to be appointed Federal Reserve agent. The Board attached particular importance²² to this selection

²¹ The men who constituted the first board of directors of the Federal Reserve Bank of New York were:

Name	Residence	Group
<i>Class C</i>		
Pierre Jay, Federal Reserve Agent and Chairman of the Board of Directors	New York City	NOTE: The group number refers to the classification of the bank which <i>nominated</i> the director. It does not mean that the director in each case was associated with a bank belonging to that particular group. Thus, every Class A director was an officer of banks in Group 1, that is, the group comprising the largest banks.
Charles Starek, Deputy Federal Reserve Agent and Vice Chair- man of the Board of Directors	New York City	
George F. Peabody	Lake George, N. Y.	
<i>Class A</i>		
William Woodward	New York City	1
Robert H. Treman	Ithaca, N. Y.	2
Franklin D. Locke	Buffalo, N. Y.	3
<i>Class B</i>		
H. R. Towne	New York City	1
William B. Thompson	Yonkers, N. Y.	2
Leslie R. Palmer	Croton-on-Hudson, N. Y.	3

For a list of all the directors of the Federal Reserve Bank of New York, showing occupation, tenure, etc., see Appendix II, facing p. 412.

²² Upon announcing its selection of government directors for the Federal Reserve banks, the Federal Reserve Board issued the following statement:

"In selecting the directors the board has made the utmost efforts to weigh and compare the merits of all those whose names were presented to it. It has also inquired into the qualifications of all other suitable men as to whom it could get information, to the end that in every case the best might be chosen.

and when it announced its appointments on October 1 they were greeted with considerable satisfaction.²³

Selection of Executive Staff

The framers of the Federal Reserve Act had intentionally omitted from the Act details regarding the internal organization of the Federal Reserve banks.²⁴ The Federal Reserve Act provided that the board of directors of the Reserve Bank had power to appoint officers and employees not otherwise provided for in the Act. But it also provided for the appointment of one of the government directors as Federal Reserve agent and outlined in considerable detail his functions and duties. This provision for the Federal Reserve agent caused no little anxiety among bankers for a while after the passage of the Act. They were fearful that the Federal Reserve agent was either intended to be the operating head of the Bank or would in some way be made such.²⁵ There was no such intention, however, on the part of the framers of the Act, it being expected that each of the Federal Reserve banks would have a practical banker as its executive manager.²⁶ The member banks desired that such a head be chosen by them. The members of the Federal Reserve Board reached an understanding after consultation with the framers of the Act that the Reserve banks should have operating heads distinct from the Federal Reserve agents and so notified the board of directors of the Bank.²⁷

Members of the board have made special journeys for the purpose of investigating conditions in various Federal Reserve cities and of ascertaining facts regarding those who were being considered by the Board. In other instances persons have been invited to Washington for consultation.

"In each case the board has endeavored to assure itself that the man selected is able to comply with the requirements of the Federal Reserve Act, is a man of ability and has the confidence of the banking and business community in which he is placed. So far as reasonably possible geographical considerations have been taken into account in order that different portions of each district might be represented on the board of directors." *The Financial Age*, Oct. 3, 1914, p. 555.

²³ *The New York Times*, Oct. 2, 1914.

²⁴ Willis, *The Federal Reserve System*, p. 687.

²⁵ *Ibid.*, p. 259.

²⁶ *Idem.*

²⁷ *Annual Report of the Federal Reserve Board*, 1914, p. 120.

The question of a proper title for the operating head engaged the attention of the Federal Reserve Board and it was finally decided that he was to be known as "governor."²³

The position and title of governor were not provided by the Federal Reserve Board until October, 1914. However, during the preceding spring when the election of directors was on foot it is understood that various bankers in New York had discussed the question whom they wanted to manage the Reserve Bank in the city and undoubtedly agreement among them had been reached regarding Mr. Benjamin Strong for the place. It is understood that this decision was well known to the member of the so-called "Wall Street Group" of New York bankers, Mr. P. M. Warburg, and that it was probably considered by him at the time when he accepted appointment as a member of the Federal Reserve Board. Mr. Warburg was heartily in sympathy with the choice of Mr. Strong and it was well understood that he would support it, as he did.

Shortly after completion on October 5, 1914, the board of directors of the Reserve Bank held its first meeting in the directors' room of the Bank of the Manhattan Company, 40 Wall Street, New York. This meeting, presided over by Mr. Pierre Jay, chairman of the board and Federal Reserve agent, resulted in the election, without controversy, of Mr. Strong as governor of the New York Reserve Bank in accordance with previous indications. Mr. Strong was at the time president of the Bankers Trust Company but was in a rather unhappy position in relation to his directors. As a result he was in a duly receptive attitude for the new position with the Reserve Bank at a salary of \$30,000 in lieu of the \$50,000 he was then receiving as head of the Bankers Trust Company. The several Federal Reserve banks did not adopt an identical policy with reference to the selection of a governor. Most of them, like the New York Reserve Bank, went outside of their own boards of directors for this official. The Federal Reserve Banks of Philadelphia,

²³ Willis, *The Federal Reserve System*, p. 698. Later the Federal Reserve Board bitterly regretted their attaching the title of "governor" to the operating officer of the Federal Reserve banks.

Richmond, and Dallas, however, selected governors from their own directors.

The Problem of Opening the Federal Reserve Banks

The Secretary of the Treasury was to set the date for opening the Reserve banks according to the Federal Reserve Act. In May, 1914 it was the hope of Treasury department officials to place the banks in operation by August 1.²⁹ As late as the last of June they still thought it possible to open the banks by this date.³⁰ But with the organization of the Federal Reserve Board itself delayed until the 10th of August, such an early opening was impossible. By the time the Board was organized the European War was in progress and conditions in the foreign exchange and commodity markets were quite upset. These and foreign relations occupied the attention of the Administration and tended to delay not only the formation of the Federal Reserve Board but the establishment of the Federal Reserve banks. But upon assuming office the question of opening the banks occupied the attention of the members of the Board and was discussed at many long conferences which took place daily throughout the summer.

The opinion was frequently expressed that "the opening of the Federal Reserve banks should be deferred until the return of more normal conditions."³¹ The Secretary of the Treasury on the other hand was insistent upon opening the banks at the earliest possible moment and most of the members of the Board had the same feeling about it. When Secretary McAdoo announced this intention the first week in September, the bankers in New York City let it be known that they considered it extremely hazardous to open the Reserve banks as long as the European War lasted.³² Determined pressure was brought to bear upon Secretary of the Treasury McAdoo to defer practically indefinitely the

²⁹ The Financial Age, May 16, 1914, p. 863.

³⁰ The Financial Age, June 27, 1914, p. 1134.

³¹ W. P. G. Harding, *The Formative Period of the Federal Reserve System*, p. 26.

³² The Financial Age, Sept. 5, 1914, p. 406; Sept. 12, 1914, p. 452.

opening of the new financial institutions. When it became evident that nearly all of the members of the Federal Reserve Board could not be dissuaded in their desire to have the Federal Reserve system in condition to render effective service to the country as quickly as possible, the next effort of the opposition was to try to have the New York Reserve Bank opened first and postpone to some indefinite date the opening of the other Reserve banks.

The Federal Reserve Board invited the directors and governors of all the Reserve banks to a meeting with the Board in Washington, October 20-22, to consider the various problems confronting them. At this meeting Secretary McAdoo was emphatic that he expected to have all the Reserve banks opened at the same time³³ and tentatively named November 16 as the date. This brought forth considerable opposition from the directors and governors assembled, including those of the New York Bank, about half of the convention opposing the opening. They also stated in support of their stand that the member banks would be weakened at that critical period by having gold withdrawn from their vaults and placed with the Reserve banks. They went so far as to declare that it would not be possible to put the banks in operation at that time.³⁴ What the opponents of the early opening of the banks failed to realize was the greater strength which would accrue to the member banks by uniting and depositing their gold with the Reserve banks. In the face of this determined opposition, Secretary McAdoo, however, asserted his independence and exercised his prerogative. He decided definitely after the convention was concluded that he would order the Federal Reserve banks opened on November 16, believing that such was for the general good of the country. His statement in part follows.³⁵

The Federal Reserve Act imposes upon the Secretary of the Treasury the duty of announcing, in such manner as he may elect, the establishment of a Federal Reserve bank in any district. In

³³ The Financial Age, Oct. 24, 1914, p. 663.

³⁴ Willis, The Federal Reserve System, p. 645; The Financial Age, Oct. 24, 1914, p. 663.

³⁵ The Financial Age, Oct. 31, 1914, p. 850.

the discharge of that duty I have determined to announce on the 16th day of November, 1914, the establishment of the Federal Reserve banks in all the Federal Reserve districts. On that date the new reserve requirements for national banks, as prescribed by the Act, will become operative.

I am compelled to this decision particularly because of the emergent conditions in the South and the confident belief that the prompt opening of the Reserve banks will be very helpful to the cotton situation and to general business in all sections of the country.

This conclusion has been reached after a thorough discussion with my associates on the Federal Reserve Board, who are co-operating cordially with me, and also after full consideration of the views expressed by the directors of the Federal Reserve banks at their recent conference in Washington with the Federal Reserve Board. . . .

Those on the Board who had opposed the early opening of the Reserve banks did not coöperate with the Secretary and when he issued this announcement they assailed it as an unwarranted assumption of authority. But they were in the minority and when it was pointed out to them that the Federal Reserve Act vested the power to determine the date of opening in the Secretary of the Treasury they could do nothing but let the judgment of Secretary McAdoo determine the issue.³⁶

The Secretary of the Treasury Orders Opening

Secretary McAdoo's order for the opening was received at the New York Reserve Bank on October 26 and was as follows: ³⁷

PIERRE JAY,

Chairman Board of Directors,
Federal Reserve Bank, New York.

Please call a meeting of the directors of the Federal Reserve Bank of your district and advise them that all necessary statutory requirements having already been complied with by the several Federal Reserve banks, the Comptroller of the Currency will forward to each bank on or before November 16, 1914, the certificate authorizing such bank to commence business as prescribed by section 4 of the Federal Reserve Act, and the Secretary of the

³⁶ Willis, *The Federal Reserve System*, p. 645.

³⁷ Annual Report of the Federal Reserve Bank of New York, 1915, p. 8.

Treasury will, in conformity with section 19 of the Act, formally announce the establishment of the Federal Reserve banks in each of the Federal Reserve districts on the 16th day of November, 1914. Please also assure the directors that this department will gladly extend to them every facility and all possible assistance in opening the banks on that date and also assure them of my very best wishes and of my earnest desire to coöperate with them in every possible manner to render this great public service.

W. G. McADOO,
Secretary of the Treasury.

The directors of the New York Reserve Bank assured Secretary McAdoo of their desire to coöperate with his plan in a telegram sent on October 28, which was as follows: ³⁸

HON. W. G. McADOO,
Secretary of the Treasury, Washington.

At the meeting of the directors of the Federal Reserve Bank of New York today your telegrams of Monday to Gov. Strong and myself were presented, and I was authorized to express to you the entire concurrence of the board of directors in the telegraphic replies sent you on Monday by Gov. Strong and myself and to thank you for your good wishes and offer of assistance and to assure you of their desire to coöperate with your plan.

PIERRE JAY, Chairman.

Following the receipt of Secretary McAdoo's order, Mr. Jay said that he and Mr. Strong would "coöperate loyally" with Secretary McAdoo in the effort to open the bank by November 16.³⁹ There was a great deal to be done in three weeks to accomplish that purpose. When the request for the opening came on October 26, the New York Reserve Bank may be said to have consisted of only the board of directors, the Federal Reserve agent, and operating head. Banking quarters had not been secured nor had a staff been assembled. The Federal Reserve Board designated November 2 as the day on which member banks were to pay the first installment on their subscribed capital stock. By special arrangement this money was received at the New York Clearing House with the assistance of a number of men from the New York banks.⁴⁰ While there were on

³⁸ Idem.

³⁹ The New York Times, Oct. 22, 1914.

⁴⁰ Annual Report of the Federal Reserve Bank of New York, 1915, p. 9.

file over 2,000 applications for positions with the new institution, the officers did not attempt to select a permanent staff in so short a time but secured the temporary services of experienced officers and clerks detailed for the purpose from the larger New York banks.⁴¹ Banking quarters were leased at 62 Cedar Street and possession was taken on Monday, November 9. During that week the officers and clerks of the new Bank met daily for drill in the various branches of the work. The certificates authorizing the Federal Reserve banks to commence business, in accordance with section 4 of the Federal Reserve Act, were signed by the Comptroller of the Currency on November 14 and provided formal authority for the announced opening.⁴²

The New York Bank Begins Operations

On schedule time on the morning of November 16 the Federal Reserve Bank of New York commenced operations with a staff of seven officers and eighty-five clerks.⁴³ The occasion was one of special interest and was recognized as such by many prominent bankers of the district who came and extended their felicitations to the officers and directors. Representatives of the British Chancellor of the Exchequer⁴⁴ also called. The event was hailed as marking the beginning of a new era, full of promise for greater financial stability.

Pursuant to a request from the Federal Reserve Board member banks were engaged on the opening day in paying the first installment on their reserves to the Reserve Bank. In order to facilitate the work of counting the money the banks generally coöperated with the Federal Reserve officials by sending gold certificates of the larger denominations. The large New York City banks not only did this but also paid their reserves so far as possible by orders on the New

⁴¹ *Idem*.

⁴² Report of the Comptroller of the Currency, Dec. 7, 1914, p. 163.

⁴³ Annual Report of the Federal Reserve Bank of New York, 1915, p. 9. In addition to Pierre Jay, chairman and Federal Reserve agent and Benjamin Strong, governor, there were several offices temporarily filled. These were: cashier, assistant cashier, secretary, assistant secretary, treasurer, credit manager, auditor, and chief accountant. *The Financial Age*, Nov. 21, 1914, p. 945.

⁴⁴ Sir George Paish and Basil P. Blackett.

York Clearing House which called for the payment of gold or gold certificates already counted by the clearing house. This procedure was also followed when the banks paid the subscription on their capital stock. With a view to expeditious and efficient handling, payments were received at three places, the Federal Reserve Bank, the New York Clearing House, and the United States Sub-Treasury.⁴⁵ On this opening day applications for loans were received from three banks apparently with a view to making "complementary rediscounts." The first one of these was for over \$2,000,000 from the Chemical National Bank which had previously asked for permission to make the first rediscount. Its application was acted upon favorably and the bank was given deposit credit.⁴⁶ The other two were for relatively small amounts and were not acted upon. After the close of business the first balance sheet of the Federal Reserve Bank of New York was mailed to the Federal Reserve Board.⁴⁷

Upon advice of the Secretary of the Treasury the assistance of the United States Sub-Treasury in New York City was assured. Its staff coöperated with the staff of the Reserve Bank and its specialized equipment was placed at the new Bank's disposal until such time as the latter had suitable equipment of its own. Experienced money counters from the sub-treasury assisted in counting the reserves transferred from the member banks. Storage compartments in the vaults of the United States Sub-Treasury building on Wall Street were used by the Bank and by the Federal Reserve agent. Federal Reserve currency unfit for circulation was prepared in the sub-treasury for its dispatch to Washington. All gold coin received by the Reserve Bank was weighed by the sub-treasury.⁴⁸

Work of the Preliminary Committee on Organization and the Washington Conference

The Federal Reserve Act set forth no details concerning the organization of the Federal Reserve banks. For that

⁴⁵ The New York Times, Nov. 17, 1914, p. 1.

⁴⁶ The Financial Age, Nov. 21, 1914, p. 945.

⁴⁷ Annual Report of the Federal Reserve Bank of New York, 1915, p. 9.

⁴⁸ Ibid., pp. 10-11.

purpose the framers of the Act had made provision for the Reserve Bank Organization Committee. This committee decided to set up a subcommittee called the Preliminary Committee on Organization. It appointed as chairman the counsel of the House Banking and Currency Committee, Dr. H. Parker Willis. The chairman then selected a group of experts as members of the Preliminary Committee.⁴⁹ Its work consisted of an intensive analysis of the technical requirements of the Reserve banks involving organization and accounting. The results of its efforts were gathered into an exhaustive report⁵⁰ accompanied by a complete set of forms which covered such technical subjects as the organization of the Federal Reserve banks, the accounting system, regulations regarding the issue and retirement of Federal Reserve notes, the interpretation of commercial paper, by-laws for the Board, the Reserve banks, and their branches, detailed plans for putting the clearing provisions of the Federal Reserve Act into effect, and regulations governing the establishment of foreign branches.

Based upon this report, the Federal Reserve Board sent to the officers and directors of the Federal Reserve banks in October, 1914, circulars containing suggested by-laws, a set-up for a uniform accounting system, and an analysis of the organization and functions of the constituent elements of the Federal Reserve system for study and discussion.⁵¹ Appreciating the benefit which would result from the co-operation of all the Reserve banks' directors and governors, and from general similarity of aims and actions, the Board then asked the banks to send representatives to a general meeting which it determined to hold at Washington, October 20, 21, and 22.⁵² The purposes of the Board in calling the convention were to discuss matters of common interest

⁴⁹ The members of the Preliminary Committee on Organization were:

H. Parker Willis, chairman
Edmund D. Fisher
Andrew A. Benton
Joseph A. Broderick

Ralph Dawson
Stephen H. Farnham
O. Howard Wolfe

⁵⁰ Report of the Preliminary Committee on Organization to the Reserve Bank Organization Committee, June 1, 1914.

⁵¹ Annual Report of the Federal Reserve Board, 1914, pp. 74-165.

⁵² *Ibid.*, Exhibit H, p. 190.

incident to the inauguration of a central banking system for the United States. More particularly they may be grouped in two classes: 1. Questions of system policy and regulations to be issued by the Federal Reserve Board. 2. Subjects concerning the internal organization and operations of the Reserve banks. Along with the announcement of the convention the Board sent a series of questions inviting suggestions and criticisms concerning the proposals which had been sent the Reserve bank heads, which were to be discussed at the convention.

The attendance was very gratifying to the Federal Reserve Board, about one hundred persons, including directors, Federal Reserve agents, governors, and members of the Preliminary Committee on Organization being present. The delegates were divided into several committees each of which was assigned a special subject for study and report.⁵³ The experts on the Preliminary Committee on Organization and the members of the Federal Reserve Board were divided up among the convention committees to aid in their work and give them such information and advice as their previous experience and work on the problems at hand had fitted them. The subjects assigned to individual committees were as follows: ⁵⁴

(a) Legal matters and procedure: by-laws, other legal points, and the preparation of legal forms.

(b) Office quarters, equipment, and personnel: vault space, organization of staff and matters affecting officers and directors, including compensation of directors and members of the Federal Advisory Council.

(c) Rediscount: definition of commercial paper and consideration of credit bureaus.

⁵³ Circular No. 9, Federal Reserve Board, Annual Report of the Federal Reserve Board, 1914, p. 165.

⁵⁴ *Idem*. This circular gives the names of the members of the Federal Reserve Board and the Preliminary Committee on Organization and the particular committees to which they were assigned.

The members of the first Federal Reserve Board and their places of residence were as follows: William G. McAdoo (member ex-officio), New York; John S. Williams (member ex-officio), Richmond, Va.; Charles S. Hamlin, Boston; W. P. G. Harding, Birmingham; Frederick A. Delano, Chicago; Paul M. Warburg, New York; and Adolph C. Miller, Berkeley, Cal.

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(d) Duties of Federal Reserve agents: auditing of Reserve banks, note issues, the clearing of national currency.

(e) Accounting and statistics: books and forms, statements to be forwarded to the Federal Reserve Board, etc.

(f) Domestic Exchange: transit and clearing.

(g) Bonding of Federal Reserve agents, members of their staff, or other officers of Reserve banks.

(h) Mechanical devices for the keeping of accounts and statistical work.

All of the committees made reports upon these subjects before the convention adjourned.⁵⁵ These, for the most part, followed the lines already set forth in detail in the preliminary report and were adopted by the convention in a rather routine way.⁵⁶ There was thus brought about a general consensus of opinion which materially aided the early opening of the Federal Reserve banks and gave them a more auspicious start. Such was the manner by which the Federal Reserve Bank of New York and the other central banks acquired the requisite information, regulations, plan of organization, and material, which enabled them to open simultaneously on November 16, 1914, and inaugurate the new era of central banking in the United States.

Charter

Under the original Federal Reserve Act, each Reserve bank was granted a charter for twenty years. As the twenty-year period drew nearer to its close, concern was felt that the development of the central banking system might be arrested. It was believed that should consideration of charter renewal be left until the end of the period, the succession of the banks might become involved in a political controversy, such as occurred in the case of the First and Second Banks of the United States, and their charters might automatically expire. Congress, therefore, by the Act of February 25, 1927, provided for indeterminate charters. As a result the Reserve banks will continue to function unless they are dissolved by an act of Congress or are required to forfeit their franchises for violation of law.

⁵⁵ All of these reports may be found in the Annual Report of the Federal Reserve Board, 1914, pp. 167-178.

⁵⁶ Willis, *The Federal Reserve System*, p. 639.

CHAPTER V

ADMINISTRATION AND CONTROL

By-Laws

The legal basis for the administration and control of the Federal Reserve banks rests primarily upon the provisions of the Federal Reserve Act and then upon the Bank's by-laws. In section 4 of the Federal Reserve Act it was provided that the board of directors of each Federal Reserve bank shall have power to prescribe by-laws "not inconsistent with law, regulating the manner in which its general business may be conducted, and the privileges granted to it by law may be exercised and enjoyed." The organizers of the Federal Reserve system, however, did not wait for the boards of directors of the Reserve banks to be organized and permit them to formulate by-laws for their respective banks in an uncorrelated fashion. This work was to be done for them beforehand.

The Preliminary Committee on Organization first formulated a tentative set of by-laws.¹ The Federal Reserve Board then sent a tentative set to the directors of each Federal Reserve bank for their consideration with a view to bringing about "a desirable uniformity" in the organization of the Reserve banks.² Suggestions were invited and were considered by the Committee on Legal Matters and Procedure appointed at the Conference of Directors of Federal Reserve banks with the Federal Reserve Board on October 20, 1914. This Committee recommended a similar standard set of by-laws³ which was ratified by the convention with the understanding that any Reserve bank could modify them to

¹ Report to the Reserve Bank Organization Committee by the Preliminary Committee on Organization, p. 22.

² Circular No. 6, Federal Reserve Board, October 5, 1914, Annual Report of the Federal Reserve Board, 1914, p. 74.

³ Circular No. 11, Federal Reserve Board, Annual Report of the Federal Reserve Board, 1914, p. 167.

suit conditions peculiar to a district. It was substantially this set of by-laws which the directors of the New York Reserve Bank originally adopted on October 28, 1914.⁴

Method of Electing Directors

The Federal Reserve Bank of New York is a corporation having a charter from the United States Government. All of its stock is owned by the member banks of its Federal Reserve district. The member banks, as stockholders, have voting privileges which entitle them to elect six out of the nine directors of the Bank. For the purpose of voting for directors, the Federal Reserve Board, in 1918, reclassified the member banks in the New York district into three groups, each group to consist as nearly as may be of banks of similar capitalization. The previous requirement that the groups were to consist also of approximately equal numbers of banks had been eliminated. The Board's classification was as follows: ⁵

- Group 1. Banks having capital and surplus in excess of \$1,999,000.
- Group 2. Banks having capital and surplus not exceeding \$1,999,000 and not below \$201,000.
- Group 3. Banks having capital and surplus below \$201,000.

This classification is in effect at the present time but the number of banks in the three groups differs widely. Group 3 contains the greatest number of banks. Group 2 is next with about three-fourths the number in Group 3. The number in the group of banks with the largest capitalization totals only a small fraction of the number in each of the other two groups.

In the matter of electing directors of the New York Reserve Bank, the procedure has been changed. While there has been technical compliance with the Federal Reserve Act, the practice has come to be something different from that intended by the authors of the Act. The procedure now

⁴ With a few minor amendments, these by-laws appear in the Annual Report of the Federal Reserve Bank of New York, 1915, p. 57. Occasional amendments have been made to the by-laws to date. The by-laws in effect since January 19, 1928, are in Appendix I, p. 409.

⁵ Annual Report of the Federal Reserve Bank of New York, 1918, p. 36.

is this: The bankers' associations of the states served by the Federal Reserve Bank of New York—New York, New Jersey, and Connecticut, have coöperated to appoint a committee. When there is a vacancy on the board of directors to be filled by the member banks, this committee canvasses the situation and recommends some one to the member banks for the nomination. Before this recommendation is made it is ascertained whether the person so chosen will serve on the board. It has been the custom to recommend only one man for the nomination. Here begins the formal compliance with the Federal Reserve Act. A number of member banks of the group concerned send in the name of the person recommended as the nominee. No other nominations are made.

There is no contest in the election, there being only one candidate up for a vacancy. Some of the member banks then go through the formality of filling out a ballot for this one candidate and sending it to the Federal Reserve agent of the Bank as provided in the Federal Reserve Act. Thus, it is all a "cut and dried" matter, the banker-elected directors of the Reserve Bank being already chosen in reality, though not nominally, by this committee of the state bankers' associations. When the recommendations for nominations are made by the committee it has been announced that the men so recommended would replace certain men on the board of directors.⁶ It appears, therefore, that the real power in determining who shall sit on the board as Class A and Class B directors of the Reserve Bank resides in this committee of the bankers' associations of the states in the district.

As early as the second year of the Reserve Bank's history member banks exhibited quite general indifference to their voting privileges. And in the election held in December, 1917, only 84 banks cast their ballots out of a total of 224 in the group of banks then voting.⁷ In recent years, as then, a large number of member banks have been neglecting to

⁶ The New York Times, Oct. 7, 1932; New York World-Telegram, March 30, 1933. See also The New York Times, April 18, 1933.

⁷ Annual Report of the Federal Reserve Board, 1917, p. 31.

vote for directors. Under the present method of seating directors, it is not strange that so many member banks fail to exercise their franchise since voting for directors is now only a perfunctory affair. Thus it is seen that, regarding the plan of the Federal Reserve Act to bring about representative control of the Reserve banks by large and small banks alike, the situation is quite different from that intended. Concerning this, Dr. Willis says: "Small banks have voted as large ones dictated; the grouping of banks for the election of directors has been unsatisfactory and artificial; the public directors have been no more public than those chosen by the banks."⁸

Service of and Interests Represented by Directors

From the time of its establishment to December 31, 1933, thirty-four men have served as directors of the Reserve Bank of New York.⁹ Over half have come from New York City. There have been several from elsewhere in New York State, a few from New Jersey, but none from Connecticut, only one county of that state being in the New York district. The period of service of the government directors has been much longer than that of either of the other two classes of directors while the Class A directors have shown the greatest turnover. Of the directors elected by the banks, those representing the banks have averaged a little over four years service,¹⁰ and those representing business have

⁸ Journal of Commerce [New York], Jan. 24, 1927.

⁹ Two new directors commenced service on January 1, 1934. For a list of all the directors of the Federal Reserve Bank of New York, showing occupation, tenure, etc., see Appendix II, facing p. 412.

¹⁰ Special mention should be made of Mr. Robert H. Treman, president of the Tompkins County National Bank of Ithaca, New York. His tenure constitutes a marked exception to that of the other Class A directors. Mr. Treman served the Bank continuously from its establishment in 1914 to December 31, 1929, as a representative of the member banks. His term of service of more than fifteen years was more than twice as long as that of any other Class A director. It was also longer than that of any other director of the Bank. In addition to being a director, he served as senior deputy governor for a period of three years from 1916 to 1919. Moreover, during these years which included the entire period of the nation's participation in the World War, Mr. Treman was acting governor for one year when the governor was absent because of ill health. From the beginning in 1914 to his retirement at the end of 1929 he

averaged four and two-thirds years. But the government directors, appointed by the Federal Reserve Board, have served an average of seven and a half years.¹¹

The occupations in which the thirty-six directors were engaged prior to or during their connection with the Reserve Bank are as follows:

Banking and finance	19
Manufacturing	9
Merchandising	4
Bank examining	1
Real estate	1
Public utilities	1
Mining	1

Of the eight men who have served as government directors, three were engaged in banking, one was a national bank examiner, one a financier, and three were chairmen of boards of directors of manufacturing corporations. Of the thirteen men who have been elected by the banks to represent "commerce, agriculture or some other industrial pursuit," six have been affiliated with manufacturing corporations, four with merchandising, and one each with mining, real estate, and public utilities.

It will thus be noted that on the board of directors of the New York Reserve Bank, in addition to the bankers of Class A, industry and trade are widely represented. The lack of influence of the agricultural interests in this district is evident from the fact that there has never been a director who was representative of agricultural pursuits. There has been some complaint that there has not been fair representation of business interests as distinguished from banking interests

attended directors' meetings, coming from his home in Ithaca, nearly every week and for a long time twice a week. (See Annual Report of the Federal Reserve Bank of New York, 1929, p. 24.)

¹¹ Another noteworthy exception to the usual length of service is that of Pierre Jay. Mr. Jay was appointed a government director, chairman of the board of directors and Federal Reserve agent at the time the Bank was organized. He served the Bank continuously in this capacity for more than twelve years, from October, 1914, to December 31, 1926, when he resigned to accept an appointment as American member of the Transfer Committee under the Dawes Plan. (See Annual Report of the Federal Reserve Bank of New York, 1926, p. 34.)

in the Federal Reserve system. When the Senate Committee on Banking and Currency was investigating the national and Federal Reserve banking systems in 1931, Owen D. Young, who had been a director of the Bank since January, 1923, first as a Class B and then as a Class C director, gave categorical answer to this question so far as the New York Bank was concerned. He said there has been "certainly ample representation of the business interests as distinguished from the banking interests" in the New York district.¹²

Influence of Stockholders

In the case of some of the Federal Reserve banks their member banks have formed stockholders' associations which hold annual meetings. These associations discuss their mutual problems, have various committees at work, and endeavor to influence the policy of their respective banks and the Federal Reserve system. The situation as regards the New York Reserve Bank is otherwise. The member banks of the New York district have never had such an organization. During its history, however, there have been a few occasions when the officers of the Bank have held a series of more or less formal conferences with member bankers. In such cases the Bank invited the member bankers in small geographical groups. Thus, a group at a time, as those from one county or section, has met at the Bank and opportunity was then offered for the presentation and discussion of the point of view of those member banks. In determining the policy of the New York Reserve Bank, the stockholders as a group exert no influence except indirectly in the selection of two-thirds of the members of the Bank's board of directors and then not in reality but only nominally.

Internal Organization

The committee of technical experts known as the Preliminary Committee on Organization laid the basis for the

¹² Hearings before a Subcommittee of the Committee on Banking and Currency, United States Senate, 71st Congress, 3rd Session, pursuant to S. Res. 71, 1931. (Hereafter cited as *Hearings on Banking Systems, 1931.*)

internal organization of the Federal Reserve banks.¹³ The Federal Reserve Board presented this committee's plan to the directors of the Reserve banks in order as it stated "to promote a desirable uniformity in the organization of the Federal Reserve banks" and "as a basis for further discussion."¹⁴ The Board recommended the adoption of a uniform system of organization in all twelve Reserve banks in so far as conditions would permit. In accordance with the varied circumstances in the several districts, circumstances involving the nature of financial transactions and the variable human element, substantially different systems of organization have developed among the banks of the system.

The internal development of the New York Reserve Bank may be divided into two periods. The first extends from the date of opening to September, 1919, and the second from September, 1919, to date. In the first two months of its existence, the temporary staff, which had been hastily assembled to provide for the opening, was gradually replaced by a permanent staff. The work of the Bank was divided among many departments, and all the operating departments were centered in the office of cashier. This first period, during which occurred the World War, involving sudden growth in the scope and volume of operations, was one of rapid adjustment to meet new situations. It was a period of experimentation consisting of almost continuous shifting of personnel and departmental organization. There was duplication of effort and lack of definite responsibility and the form of organization proved to be of a temporary character.¹⁵

In order to secure a more effective organization within the Bank and to render more efficient service to all concerned, a new system was put into effect September 2, 1919. Though some changes in departments and lines of control have been made, the general plan of organization and man-

¹³ Report of Preliminary Committee on Organization to the Reserve Bank Organization Committee.

¹⁴ Circular No. 8, Federal Reserve Board, Oct. 17, 1914.

¹⁵ Annual Reports of the Federal Reserve Bank of New York, 1915-1919.

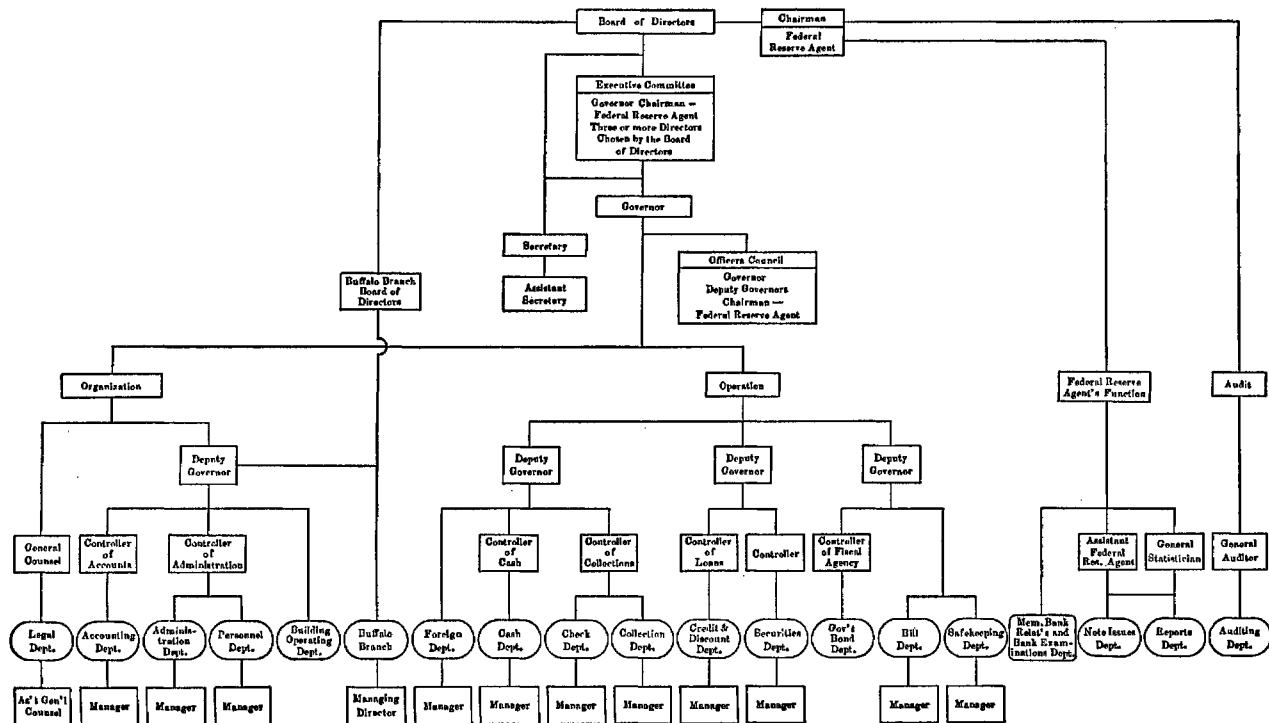


FIG. 3.—Organization of the Federal Reserve Bank of New York

agement then adopted is in effect at the present time. The entire work of the Bank is divided along functional lines, each function being under the immediate supervision of a senior officer, with the title of controller.¹⁶ The controllers are concerned with questions of policy. The responsibility of each of them is subdivided into workable units. The various functions are divided into departments presided over by junior officers called managers, each of which is responsible for the duties of operation or organization, as the case may be, which attach to his department. In many of the departments there are divisions each in the charge of a chief. The division of control and the allocation of responsibility is in some cases carried still further for several of the larger divisions are divided into sections each in the charge of a supervisor.¹⁷

Management

The management of the Bank is carried on under the supervision and control of its board of directors, the chairman of which is the Federal Reserve agent. This officer is the appointee, and is legally constituted the official representative, of the Federal Reserve Board at the Bank. The board of directors functions subject to the control vested by law in the Federal Reserve Board. And while the directors appoint their managing officers the Federal Reserve Board has power to remove any officer of the Bank so appointed. The board of directors meets once a week. For the purpose of carrying out some of its functions, and to act when it is not in session, the board of directors has an executive committee. The directors have delegated to this committee some important powers including that of passing upon all discounts and advances.¹⁸ In general the executive committee directs the business of the Bank subject to the supervision and control of the board of directors, but its work is for the most part turned over, or left, to the discretion of the governor. Responsible to the executive com-

¹⁶ See organization chart of the Bank, p. 90.

¹⁷ See organization chart of a typical function, p. 92.

¹⁸ See by-laws, Appendix I, p. 409.

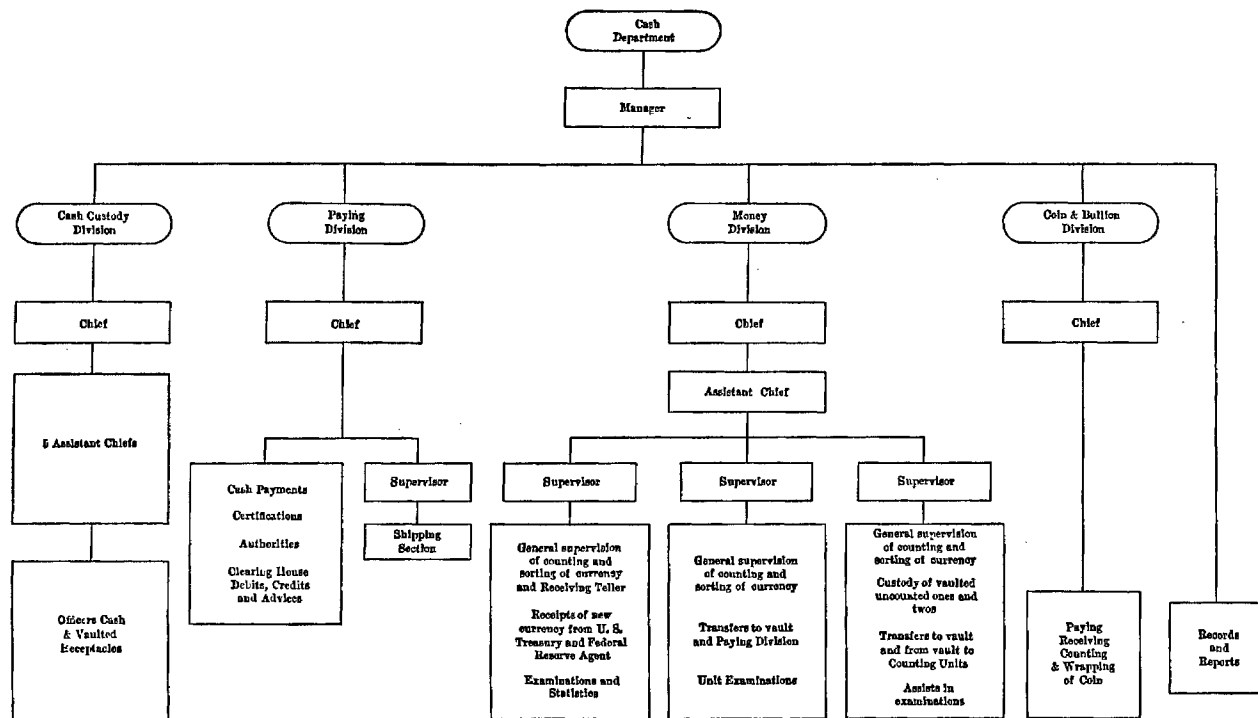


FIG. 4.—Organization of a Typical Function, Federal Reserve Bank of New York, Cash Function

mittee and the board of directors is the governor who is the operating officer of the Bank. The operating functions are allocated to several deputy governors. The governor has no functions under his special jurisdiction but controls all these functions through his deputies.

The Federal Reserve Agent and Governor

The Federal Reserve agent is charged, in the Federal Reserve Act, with certain duties and responsibilities. He is chairman of the board of directors and as such is the head of the New York Reserve Bank and is responsible for leading in the policies pursued by the Bank. He is also Federal Reserve agent and as such he is to maintain a local office of the Federal Reserve Board on the premises of the Bank and be the Board's official representative. In this capacity he is expected to be an official observer for the Board—a guarantor for the conduct of the Bank and the performance of functions conferred upon the Board by the Act. He is to make regular reports to the Board and keep it informed as to conditions in his district. As Federal Reserve agent he also issues, for the Board, Federal Reserve notes to the Reserve Bank and has charge of their withdrawal. Ancillary to this function he has charge of passing upon the collateral security tendered for the Federal Reserve notes and its safekeeping. For the purpose of carrying out these functions several departments have been organized in the Bank under the special jurisdiction of the Federal Reserve agent. These are the departments of Note Issues, Reports, Member Bank Relations, Bank Examination, and Auditing.

The title of governor is unknown to the Federal Reserve Act. It was given to the operating officer of the Reserve banks by the Federal Reserve Board under its general administrative powers upon the solicitation of one of their number who urged that it would dignify the position and make it more attractive to bankers of ability and fitness for the position. The title of governor has been traditionally held by the heads of several foreign central banks, noteworthy being the head of the Bank of England. But the

governor of the Federal Reserve Bank of New York is not in the same position as the governor of the Bank of England. The governor of the Bank of England is the chairman of the board of directors and the head of that bank. The chairman of the board of directors or chief executive officer of the New York Reserve Bank is not the governor of the Bank but an appointee of the Federal Reserve Board who in addition to his appointment to the chairmanship is designated Federal Reserve agent. The governor of the Reserve Bank occupies a position *de jure* comparable to that of the comptroller of the Bank of England or the senior general manager of a Joint Stock Bank.

The board of directors of the Reserve Bank is charged with the duty of directing the policy of the Bank and not, of course, with the execution of that policy, except in so far as it would be expected to know that the policy it formulates is carried out. Hence the chairman of the board of directors and not the governor of the Bank may be expected to lead in determining the policy of the Reserve Bank, not only because he is a member of the policy determining body but because he is the chairman of that body. Such was the intention of the provisions of the Federal Reserve Act¹⁹ and such was the decision of the Federal Reserve Board at the time of the establishment of the Federal Reserve banks.²⁰ For the purpose of executing the policy of the Bank the Federal Reserve Act provided that the board of directors should appoint officers not otherwise provided for by the Act. It did appoint an operating officer who is called governor. In the course of the development of the New York Reserve Bank, the position of governor has become one of greater importance and influence, whereas that of chairman and Federal Reserve agent has declined.

¹⁹ Hearings on Banking Systems, 1931, pp. 292-293.

²⁰ Regarding the question of the relative status of the chairman and operating head, Dr. Willis said: "... after much discussion the Board finally resolved to say to all inquirers that the distinction between the Federal Reserve agent and the operating head of the bank was to be in a general way the distinction between the maker of a policy or the developer of a general system of organization and the factor employed to carry it out." Willis, *The Federal Reserve System*, p. 689.

Subordination of Federal Reserve Agent to Governor

Let us review briefly some of the activities of the men that have held these executive positions. The chairman and Federal Reserve agent has worked for the most part quietly in the Bank. His outside activities have been largely confined to addresses before bankers and other business groups and civic organizations. On the other hand the governor, in addition to such addresses, has been head of the Central Liberty Loan Committee of the New York Federal Reserve district during the war, head of the Open Market Investment Committee of the Federal Reserve system, and representative of the Bank in the central bank conferences at home and abroad with the heads of foreign central banks. During the depression, there was held at Washington, D. C., in August, 1932, the so-called National Conference of Business and Industrial Committees, meeting upon the invitation of President Hoover. This conference voted to create a central committee to "bring Federal agencies and private business into an immediate six-point campaign to expand credit and spread employment." To this central committee were named the chairman of the banking and industrial committees of each of the Federal Reserve districts and nine other men, one of whom was the governor of the New York Reserve Bank.²¹ Here was, officially at any rate, a Federal government-initiated effort involving the coöperation of government and private agencies, but the Federal Reserve Bank official who was appointed a member of the central committee was not the chairman and Federal Reserve agent but the governor. Again, in 1932, the governor of the Bank met with the governors of the other Federal Reserve banks in Washington as often as three times in three months, and was regarded as having not only discussed but planned policies involving his own Bank and the Federal Reserve system.²²

Besides all of these means by which the policy of the Bank has been in the hands of the governor, the governor has been the dominant factor in determining the policy of

²¹ The New York Times, Aug. 27, 1932.

²² The New York Times, July 16, 1932.

the Bank by shaping the policy of the board of directors. How has this been possible since the governor is not a member of the board of directors? The stockholding member banks naturally desired to control the policy of the Reserve Bank through the office of governor. Benjamin Strong, the first to hold the office at the Federal Reserve Bank of New York, possessed a personality which supplied such leadership. Soon after the Reserve Bank was established it became the practice for the governor to sit with the board of directors in their meetings for the purpose of attaining more harmony and efficiency.²³ Though the governor was not a member of the board of directors and could not vote, this was not necessary in order for him to furnish the leadership in developing the Bank's policy. The board of directors was not only receptive but encouraged leadership on the governor's part. It was the practice of the board of directors at their weekly meetings to ask the governor if he had any recommendations to make concerning, for example, the vital question of discount policy. If the governor recommended a change, it was discussed by the directors.²⁴

While it was intimated at the time of the appointment of Benjamin Strong as governor of the Bank, that the Federal Reserve agent as chairman of the board of directors would "exercise a dominating influence over the affairs of that institution," such was not the case. Mr. Jay as Federal Reserve agent worked under the direction of Mr. Strong as governor of the Bank. And while Mr. Strong was not a member of the board of directors he sat with the board and influenced its deliberations.²⁵ This subordination of the office of chairman-Federal Reserve agent to the office of governor, although contrary to the Federal Reserve Act, has continued under Mr. Strong's successor, G. L. Harrison.²⁶

²³ Willis, *The Federal Reserve System*, p. 695.

²⁴ Hearings on H. R. 11806 before the Committee on Banking and Currency of the House of Representatives, 70th Congress, 1st Session, 1928, p. 14. (Hereafter cited as *Stabilization Hearings on H. R. 11806, 1928.*)

²⁵ See *Financial Age*, Oct. 10, 1916, p. 605, and Hearings before the Committee on Banking and Currency of the House of Representatives on H. R. 7895, 69th Congress, 1st Session, 1926, p. 859. (Hereafter cited as *Stabilization Hearings on H. R. 7895, 1926.*)

²⁶ Hearings on Banking Systems, 1931, pp. 292-293.

Another way by which the governor succeeded in dominating the policy of the Bank was through the executive committee of the board of directors of which he was the chairman. There existed, then, the anomalous situation whereby the directors' executive committee was headed by an officer who was not a director. In this way, an unofficial alteration of structure and control has come about in the organization of the New York Reserve Bank. The executive committee, as has been seen, was delegated important powers of policy and control by the board of directors. The board of directors accepted the leadership of the governor in matters of policy. The fact that six of the nine members of the board of directors were elected by the member banks and that they elected the governor made it possible for the governor to assume the leadership rather than the chairman who was an appointee of the Federal Reserve Board, representing the Government.

On questions of policy affected with a public interest, involving a possible controversy between the government directors on the one hand and the bank or private directors on the other, the balance of power rests with the directors chosen by the member banks. Fortified with this division of legal corporate power in the board of directors, of which the governor was undoubtedly aware, advantage was taken of his position as operating officer of the Bank to increase his authority and project the scope of his control over questions of general policy. In this situation there were two courses open to the chairman and Federal Reserve agent. He could make an issue of authority over certain matters as they came up, or he could permit himself to become subordinate to the governor. He chose the latter course. There is no evidence to indicate that the chairman ever made an issue of the matter of relative authority. But that he has subordinated himself to the governor in the leadership of the Bank and problems of general policy is a matter of record.

There were two other factors which tended to cause the subordination of the chairman and Federal Reserve agent to the governor of the Bank. These involved the corre-

spondence between the Federal Reserve Board and Bank and the salaries. In the beginning the Federal Reserve Board communicated with its representative at the Bank, the Federal Reserve agent and chairman. But during its first year the Board developed the practice, following the complaint of governors of the Reserve banks, of sending a duplicate communication to the governor, when it addressed the agent. The next step was that the Board addressed the governor of the Bank and sent a duplicate of the communication to its representative. And finally the Board communicated with the governor when any very important matter was involved, sending less and less duplicates to the Federal Reserve agent.²⁷ The effect of all of this was the elevation of the governor over the chairman-Federal Reserve agent.

So far as the salaries of the chairman-Federal Reserve agent and the governor are concerned the original wide divergence between them at once elevated the governor above the Federal Reserve agent. Various observers at the time considered such a difference in the salaries of the two officers a serious mistake,²⁸ some considering the salary of the governor much too high relative to the salaries of the members of the Federal Reserve Board. But bankers contended that it was necessary to offer a salary comparable to those paid the officers of the commercial banks in New York City in order to attract the kind of man to take the position of governor. On the other hand, since the chairman-Federal Reserve agent was a United States Government appointee, his salary was obliged to bear a reasonable relation to the salaries paid such officials in Washington. Thus the delicate question of adjusting salaries was decided. The annual salary of the chairman-Federal Reserve agent was set at \$16,000, while the governor was paid \$30,000.

From this financial elevation of the governor to so much higher a level of salary than the chairman-Federal Reserve agent, it was an easy step to the feeling of subordination of the office of the former to the latter. Both being officials in the same institution and both being engaged in adminis-

²⁷ Willis, *The Federal Reserve System*, pp. 699-700.

²⁸ *Ibid.*, p. 690.

trative work, the fact that the governor received nearly twice the salary paid the Federal Reserve agent could have but one meaning to the banking community—that the governor occupied the leading position in the Bank and was the superior officer of the Federal Reserve agent. The chairman, consequently, came to look upon himself as assuming a secondary rôle in the Bank and acted accordingly.

During the course of the development of the Federal Reserve system, the point of view which in the beginning determined salaries of \$16,000 and \$30,000 for the chairman-Federal Reserve agent and governor respectively of the New York Bank became modified. Not only was the salary of the governor raised to \$50,000 in 1919 but the divergence in the relative financial position between the two was gradually lessened.²⁹ Finally, in 1927, the salary of the chairman-Federal Reserve agent was raised to the same amount paid to the governor, \$50,000.

Representation of the Public

The Federal Reserve Board, which approved the increase of the chairman's salary, issued a statement indicative of the regard in which it held the office of chairman-Federal Reserve agent at the New York Reserve Bank. Said the Board:³⁰

There is no more responsible or important position in the Federal Reserve banks than that of chairman and Federal Re-

²⁹ Official salaries of the chairman-Federal Reserve agent and governor of the Federal Reserve Bank of New York, 1915 to 1933, are as follows:*

	Federal Reserve Agent	Governor		Federal Reserve Agent	Governor
1915	\$16,000	\$30,000	1925	\$30,000	\$50,000
1916	16,000	30,000	1926	40,000	50,000
1917	20,000	30,000	1927	50,000	50,000
1918	20,000	30,000	1928	50,000	50,000
1919	30,000	50,000	1929	50,000	50,000
1920	30,000	50,000	1930	50,000	50,000
1921	30,000	50,000	1931	50,000	50,000
1922	30,000	50,000	1932	50,000	50,000
1923	30,000	50,000	1933	50,000	50,000
1924	30,000	50,000			

* Compiled from the Annual Reports of the Federal Reserve Board.

³⁰ Federal Reserve Board, statement released for publication, Feb. 10, 1927.

serve agent at the Federal Reserve Bank of New York. The chairman of the board is, in a special sense, the guarantor to the Federal Reserve Board and to the public of the good functioning of his bank. In his capacity as Federal Reserve agent he is the official representative of the Federal Reserve Board at his bank.

In its first annual report, the Federal Reserve Board had stated that the Federal Reserve agent was "intended to be a government representative and spend his time in furthering the interests of the public at large, a position he could hardly preserve were he to become an active operating officer, anxious to increase profits and advance given private interests."³¹ So far as the law and the intentions of the framers of the Federal Reserve Act are concerned, he was to act in a dual capacity, being the government representative and the chief officer of the Bank. As the New York Reserve Bank has developed, the conditions of administration and control have been different from those intended.

As we have seen, the governor has been the dominant factor in determining the policy of the Bank, and the chairman-Federal Reserve agent has been reduced chiefly to a figure-head presiding at meetings of the directors and custodian of notes and collateral security.³² Furthermore, after his salary was raised to the amount received by the governor, the subordination in which the chairman was placed in the beginning continued.

In his capacity as the representative of the Federal Reserve Board, again, the chairman has not been functioning in the way that was intended.³³ Although the \$50,000 annual

³¹ Annual Report of the Federal Reserve Board, 1914, p. 121.

³² Consult also Willis, *The Federal Reserve System*, pp. 696-697; *Hearings on Banking Systems*, 1931, pp. 292-293.

Dr. Adolph C. Miller, a member of the Federal Reserve Board from the time of its organization in 1914 to date, stated before the House Banking and Currency Committee that he was of the opinion that the position of chairman-Federal Reserve agent should be broken up into two positions—"one, chairman of the board of his bank, and the other, Federal Reserve agent—the Federal Reserve agent to be a functionary in the bank, an agent of the Federal Reserve Board on the premises of the bank for the issuing of notes, etc., but not a director of the bank; the chairman to be the official representative of the Board in its relations with the Reserve bank." *Stabilization Hearings on H. R. 7895*, 1926, p. 859.

³³ *Stabilization Hearings on H. R. 7895*, 1926, p. 859.

salary which the Federal Reserve agent has received from 1927 evidences the regard in which the Board holds the position, in actual practice, as a subordinate to the governor of the Bank he has been more or less interested in the operation of the New York Reserve Bank as against general policy and the point of view of the Federal Reserve Board.³⁴

An outstanding instance of ill consideration of the public's interest is afforded by the failure of a large member bank in New York City in 1930.³⁵ This involves one of the functions of the Reserve Bank, that of the examination of member banks, which had been specifically assigned to the Federal Reserve agent. The management of the failed member bank had been addicted to the practice of organizing real estate security-holding affiliates. These security affiliates were engaged in buying up securities and speculating in the stock of the bank itself. The bank commonly made loans to individuals and corporations on their notes, which merely represented real estate equities, and also on notes collateralized with the stocks of real estate affiliates. Furthermore, the bank issued new shares of its own stock coupled with shares of stock in an affiliated securities corporation.

It was generally known in usually well-informed quarters that these things were going on and that the condition of the member bank was in bad shape.³⁶ Chairman Case, the Federal Reserve agent, declared that the officers of the Reserve Bank had not had "full confidence" in the management of the member bank for a period of years.³⁷ Presumably then, the Federal Reserve officers possessed at least general knowledge of what was going on. And yet the Federal Reserve agent, under his examination function,

³⁴ Idem.

³⁵ The member bank was the Bank of United States, a state bank chartered by the state of New York. It had no connection with the Government of the United States. It was unfortunate that it possessed the title it did. Such a bank could not have used the name "United States" in its title if it had been organized after a law enacted in 1926 regarding limitation on the use of the words "Federal," "United States," or "Reserve." (Act approved May 24, 1926; 44 Stat., 628.)

³⁶ Hearings on Banking Systems, 1931, p. 498. See also page 311 of these hearings.

³⁷ Ibid., p. 116.

did not find out in good season the non-liquid condition of the bank's assets; or if he did know of this condition he did not announce or publish his findings for the protection of the public. The member bank subsequently failed causing the loss of millions to depositors and dire distress.³⁸

The government directors, of which the chairman-Federal Reserve agent is one, have been no more "public" than those chosen by the banks.³⁹ The Federal Reserve agent has been for the most part an operating officer, a local New York Reserve Bank official, interested in his particular bank.⁴⁰

Governors Council

About the time of the organization convention at Washington in October, 1914, there was formed the Governors Council whose chairman was the governor of the Federal Reserve Bank of New York. The council had a paid secretary who was also an officer of the New York Reserve Bank. There has never been any published statement as to the origin of the idea or of the actual organization of this council. It has been supposed that the project originated with some of the officers of the larger banks or with one of the original members of the Federal Reserve Board.⁴¹ The first record of such an organization is contained in the report of one of the committees of the convention of officers and directors of the Federal Reserve banks held at Washington in October, 1914.⁴² This report was by the committee on rediscount which was the only committee on which the Board member referred to sat. In its report under date of October 21, 1914, the committee said:

³⁸ At the time of closing the deposits amounted to about \$160,000,000.

³⁹ Cf. *Journal of Commerce* [New York], Jan. 24, 1927.

⁴⁰ Before the Senate Committee on Banking and Currency, in 1928, Professor Willis commented thus: "We had supposed that the establishment of the Reserve system had been to supervise our banking and make its action more public spirited than it was under the old banking system; but the actual working out shows how difficult it is for anyone to foresee the future. It has not done it." Hearings before the Senate Committee on Banking and Currency on S. Res. 113, 1928, pp. 24-25. (Hereafter cited as *Hearings on Brokers' Loans*, 1928.)

⁴¹ Willis, *The Federal Reserve System*, p. 703.

⁴² *Annual Report of the Federal Reserve Board*, 1914, p. 171.

It is believed wise that an executive council should be formed, consisting of the twelve governors, with the deputy governors as alternates, to which should be referred the matter of determining the date and manner of undertaking, from time to time, such additional functions as the following:

[Here follows a list of important powers devolving upon the Federal Reserve Board by the Federal Reserve Act.]

In order that the very minimum of machinery may be employed in the first days of operation it is thought that even (a) transfers between member banks and (b) transfers between Federal Reserve banks should be deferred until the *executive council*⁴³ suggested is satisfied that the necessary preliminaries have been arranged for such transactions.⁴⁴

Here we have the first intimation of this extra-legal organization, headed by the governor of the New York Reserve Bank, setting itself up as practically a higher directing authority than the Federal Reserve Board.

The first formal meeting of the Council of Governors took place in Washington, December 10–12, 1914.⁴⁵ The governor of the New York Reserve Bank was elected head of the council and also the head of a committee which functioned in a sort of inter-regnum capacity.⁴⁶ Thereupon, a cleavage between this council and the Federal Reserve Board arose concerning, fundamentally, the question of who should control the affairs of the Federal Reserve system—the managers of the Federal Reserve banks or the Federal Reserve Board. The Federal Reserve Board, or a majority of its membership, held that the Federal Reserve Act gave such control to the Board. As an example of the peremptory attitude of the governors, at their December, 1914, meeting, the New York Reserve Bank reported that “it was decided to continue for a few months the practice of receiving at par checks on Federal Reserve banks in order to observe the results of facilitating in this way the transfer of money between the twelve Federal Reserve cities.”⁴⁷

The attitude of the council and its members became more

⁴³ Italics are the author's.

⁴⁴ Annual Report of the Federal Reserve Board, 1914, pp. 171–172.

⁴⁵ Annual Report of the Federal Reserve Bank of New York, 1915, p. 13.

⁴⁶ The New York Times, Dec. 12, 1914, p. 8.

⁴⁷ Annual Report of the Federal Reserve Bank of New York, 1915, p. 13.

and more domineering. Referred to as the "council," a concession to the feeling of the Federal Reserve Board was made, beginning probably in 1916, when it was called the Governors Conference or Conference of Governors.⁴⁸ Under this title the governors held four formal meetings each year in 1916 and 1917. Very little ever got into the newspapers about such meetings or the activities of the governors, but they apparently worked consistently to undermine the power of the government board. Their assumption of authority and refusal to carry out the instructions of the Federal Reserve Board continued to such length, however, that when Mr. Harding assumed office as governor of the Board, he resolved to terminate the governors' assumption of extra-legal authority. Governor Harding informed the Reserve bank governors that the Board could not allow the meetings of the Governors Conference to continue. Such a policy was carried out during the period of Mr. Harding's governorship. The Federal Reserve Board could not prevent the twelve governors of the Federal Reserve banks from getting together and discussing their mutual problems and there never had been any reason why it should do so.⁴⁹ But what it did feel was unauthorized was the formal organization of the managers of the Reserve banks and the assumption of powers of the Federal Reserve Board.⁵⁰

The New York Reserve Bank governor was the dominant figure of this group and he was usually made chairman of the organization. The idea of a body of Reserve bank officials grouped around the New York Bank's official and not subject to administrative or governmental control continued to persist. In 1922 the governors demanded the right "to meet officially when and where they would for the purpose of independent deliberation, free of supervision [and presumably of the presence of any members] of the Federal Reserve Board itself."⁵¹ The policy decided upon at that time was that the Board would summon the governors to

⁴⁸ Willis, *The Federal Reserve System*, p. 705.

⁴⁹ *Ibid.*, p. 707.

⁵⁰ *Hearings on Banking Systems*, 1931, p. 157.

⁵¹ Willis, *op. cit.*, p. 708.

Washington for recognized meetings at which would be present one or more members of the Federal Reserve Board.⁵² This the Board has done and such meetings have been held each year.

The Open Market Policy Conference,⁵³ which was in existence from March, 1930 to June, 1933, was composed of representatives of all the Reserve banks and in practice of their governors. The Open Market Policy Conference did not supersede the Governors Conference. Both organizations consisted of the same body of men but acting in a different capacity.⁵⁴ In recent years, the so-called Governors Conference has met only upon the invitation of the Board and it has come to be in effect a conference of governors with the Federal Reserve Board.⁵⁵ While the Governors Conference is not defunct it is responsible to the Federal Reserve Board and it was stated by a member of the Board that "its deliberations are mainly confined to technical matters."⁵⁶ Thus the effort and apparent tendency in the early years of the system to form a central body of governors headed by the representative of the New York Bank, which would act authoritatively, independent of the Federal Reserve Board, and, therefore, practically supersede that central authority created by the Federal Reserve Act, was unsuccessful.

⁵² *Idem.*

⁵³ See chapter VIII, p. 174.

⁵⁴ Hearings on Banking Systems, 1931, p. 157.

⁵⁵ *Idem.*

⁵⁶ Testimony of Adolph C. Miller, *idem.*

CHAPTER VI

FINANCES

Sources of Funds

The funds with which the Federal Reserve banks commenced business in November, 1914, were furnished entirely by the member banks. They were secured by the sale of capital stock to the member banks and by the deposit of their reserves. The amount of the capital stock of the Reserve banks depended upon the amount of the capital and surplus of the member banks. Each member bank was required to subscribe for capital stock of the Reserve Bank in an amount equal to 6 per cent of its capital and surplus. One-half of the subscribed amount had to be paid while the remaining half was subject to the call of the Federal Reserve Board. The Board has never called for the second half. The capital stock of a Reserve bank, therefore, increased or decreased with the increase or decrease in the number of its member banks and their capital and surplus.

All reserves of the member banks were required (since June, 1917) to be kept at the Federal Reserve banks and there was a legal minimum for such reserves which consisted of a percentage of the deposit liabilities of the member banks. The Reserve banks also secured working capital by accepting deposits of the United States Government, non-member clearing banks, and foreign central banks. The Reserve banks have not accepted deposits from individuals or business concerns. The bulk of the New York Reserve Bank's deposits have been those of its member banks. In addition to the above sources of funds, the Reserve banks increased their assets by profits which were transferred to surplus in due course according to statute.

Total Earnings

The first year earnings of the New York Reserve Bank were merely nominal. They were not sufficient to cover all

the expenses. There was very little demand for loans in the money markets. On the other hand, reduction in the reserve requirements of member banks resulted in the availability of a plethora of bank credit. Reserve banks did not wish to compete with member banks in discounting bills in the open market. In the second year, a slightly better record was made but it was not until our participation in the World War that earnings began to mount. Beginning in 1917, they increased rapidly till they reached their peak for all time in 1920 at \$60,000,000. These large earnings reflected the unusual fiscal operations of the Government in connection with financing the war. In 1921 the earnings were about the same as for 1919 but for each of the following years they have been markedly less. In the post-war years, significant is the period of wild speculation in securities which some were wont to call the "new era," the idea being that new levels in stock prices were reached which would not drop to former levels.

This era of stock speculation, which began in 1925 and collapsed in October, 1929, reflects the increasing activity of the New York Reserve Bank in the stock market by supplying funds to member banks and buying securities in the open market. This activity of the Bank resulted in greatly enlarged income. During this time the earnings of the Bank increased from \$10,000,000 in 1925 to \$19,000,000 in 1929. The depression years of 1930 and 1931 showed a great falling off in earnings, the Bank being unable to pay dividends the latter year without drawing on its surplus.¹ The large increase of earnings during 1932 and 1933 over the previous two years, in spite of the continuing depression, reflected the extra effort to stimulate business recovery by forcing excess reserves upon member banks by buying government securities.

During the decade of the '20s the earnings were materially reduced below what they otherwise would have been because of the presence of the market for federal funds. This market originated in 1921 with the sale by some member banks in New York City of their excess balances at the

¹ See Table 4, p. 114.

Reserve Bank to member banks in debt at the Bank. Since then the federal fund market has developed to a high degree. The use of the federal fund market means that (1) banks in debt to the Reserve Bank have been able to liquidate their indebtedness by borrowing, for a day at a time, from commercial banks, and (2) banks with deficiencies in their reserve accounts may make them up not by borrowing from the Reserve Bank but by borrowing the excess Federal Reserve balances of other banks. By this practice the banks have brought about a curtailment of the earnings of the Reserve Bank.

Sources of Earnings

The earnings of the Reserve banks have been derived generally from interest on rediscounts and advances to member banks and interest on securities and acceptances purchased in the open market. A few miscellaneous sources augmented these incomes slightly.² During its first two years, the New York Reserve Bank's loans and discounts were so nearly zero that it adopted the policy of buying municipal warrants and acceptances in order to meet expenses. During this period also, part of the Bank's income consisted of "service charges," that is, charges at one cent per item made to member banks depositing checks with the New York Reserve Bank for collection. Such charges, however, were abandoned about the middle of 1918.

Interest on discounted bills, which include rediscounted paper, has comprised the major part of the New York Bank's earnings. A very large proportion, however, of the earnings from this source was secured during the relatively brief period of war-financing. The year 1930 witnessed a sharp drop in such earnings and they continued at a low level during the succeeding depression years, reflecting the depressed activity of business and the fall in interest rates. During the four years, 1930-1933, more than two-thirds of the total earnings of the New York Bank were derived from United States Government securities. This extremely high

² See Tables 1 and 2, pp. 109, 111.

TABLE 1
EARNINGS OF THE FEDERAL RESERVE BANK OF NEW YORK, BY SOURCES *
(Before deduction of expenses)

Year	Earnings					
	Total	On Discounted Bills	On Purchased Bills	On U. S. Government Securities	Deficient Reserve Penalties	From Miscellaneous Sources
1914-15	\$ 345,035	\$ 36,782	\$ 97,135	—	—	\$ 211,118
1916	971,026	37,368	530,484	\$ 81,645	—	321,529
1917	4,929,214	2,455,533	1,843,325	378,668	\$ 18,565	233,123
1918	25,314,736	17,736,261	5,411,821	1,561,839	27,192	577,623
1919	35,332,412	29,935,911	3,334,605	1,888,497	36,405	136,994
1920	60,525,321	49,839,183	8,323,050	1,975,649	141,664	245,775
1921	34,710,274	30,762,021	1,829,665	1,955,970	63,804	98,814
1922	11,349,279	3,970,210	1,619,512	5,227,488	49,738	482,331
1923	11,413,183	8,255,646	1,969,837	1,087,251	40,800	59,649
1924	8,569,350	2,613,566	1,446,693	4,165,856	24,974	318,261
1925	10,217,174	5,188,506	1,469,858	2,984,698	33,422	540,690
1926	10,600,968	5,836,836	2,001,668	2,379,546	45,386	337,532
1927	10,647,759	4,614,110	2,558,080	2,960,563	28,680	486,326
1928	18,483,042	12,210,527	3,482,649	2,421,172	46,009	322,685
1929	19,314,279	12,492,642	3,522,642	2,459,163	96,076	743,756
1930	10,393,189	1,910,378	1,917,937	5,895,425	27,066	642,383
1931	7,555,213	1,661,805	1,638,210	3,613,854	17,425	623,919
1932	15,948,943	3,276,595	932,505	11,157,507	44,367	537,969
1933	17,523,930	2,572,465	288,117	14,255,732	19,476	388,140
Total	314,144,327	195,406,345	44,217,793	66,450,523	761,049	7,308,617

* Compiled from the Annual Reports of the Federal Reserve Board.

proportion of earnings from "governments" reflected the Bank's effort to break the depression by pumping credit into the market.

The figures given for earnings on discounted bills include interest on the promissory notes of member banks secured by eligible collateral. Although the bulk of such collateral has consisted of government securities, officers of the Bank have, on numerous occasions, stated that the member banks had at the time of application for such loans an amount of eligible commercial paper in their portfolios at least equivalent to the amount of Federal Reserve credit applied for. The extensive development of borrowing excess Federal Reserve balances of other banks in lieu of borrowing from the Reserve Bank has accounted for a curtailment of earnings on discounted bills.³

The significant proportions that open market operations have assumed is evidenced in the fact that over one-third of the total earnings has been derived from them. Earnings from acceptances and United States Government securities purchased in the open market have exceeded those from loans and discounts in nine years—1914, 1916, 1922, 1924, 1927, and 1930 to 1933. In the case of the first two years the Bank was trying to get on its feet, and in the absence of scarcely any demand for rediscounts, endeavored to pay expenses and meet dividend requirements by buying interest-bearing securities. In 1922 the purchases were made with the same ends in view. In 1924 and 1927 the Bank was motivated by an "easy money" policy for a variety of reasons. During the four years of 1930 to 1933 the Bank purchased heavily for the purpose of creating an upturn in the security and commodity markets. While in the case of single years and the entire period, as between Federal Reserve banks, there have been wide variations in the relative amounts of earnings derived from their various sources, the figures for the Federal Reserve system are strikingly similar to those of the Federal Reserve Bank of New York.

³ See above, pp. 107-108.

TABLE 2

EARNINGS OF ALL FEDERAL RESERVE BANKS, BY SOURCES *
(Before deduction of expenses)

Year	Earnings					
	Total	On Discounted Bills	On Purchased Bills	On U. S. Government Securities	Deficient Reserve Penalties	From Miscellaneous Sources
1914-15	\$ 2,173,252	\$ 1,218,516	\$ 244,664	\$ 171,831	—	\$ 538,241
1916	5,217,998	1,025,675	1,560,918	1,106,860	\$ 1,157	1,523,388
1917	16,128,339	6,971,479	4,951,729	2,367,989	194,526	1,642,616
1918	67,584,417	48,348,007	11,939,808	3,828,782	698,991	2,768,829
1919	102,380,583	80,768,144	13,994,544	5,761,300	727,844	1,128,751
1920	181,296,711	149,059,825	22,020,158	7,140,615	1,573,335	1,502,778
1921	122,865,866	109,598,675	5,234,141	6,253,854	1,177,562	601,634
1922	50,498,699	26,523,123	5,628,956	16,682,463	602,951	1,061,206
1923	50,708,566	32,956,293	9,371,288	7,444,089	521,061	415,835
1924	38,340,449	15,942,845	5,709,809	14,712,593	381,619	1,593,583
1925	41,800,706	17,679,549	9,103,915	12,783,001	310,406	1,923,835
1926	47,599,595	22,551,561	10,003,081	12,589,119	382,946	2,072,888
1927	43,024,484	17,010,778	9,206,677	14,206,174	273,839	2,327,016
1928	64,052,860	38,334,140	13,020,535	10,827,702	277,401	1,593,082
1929	70,955,496	47,790,662	12,063,349	8,163,486	449,653	2,488,346
1930	36,424,044	10,672,215	6,081,187	17,273,331	225,748	2,171,563
1931	29,701,279	9,820,546	5,009,541	12,428,297	296,960	2,145,935
1932	50,018,817	17,881,058	2,785,213	26,923,568	541,432	1,887,546
1933	49,487,318	9,137,038	1,238,068	37,529,872	191,051	1,391,289
Total	1,070,259,479	663,290,129	149,167,581	218,194,926	8,828,482	30,778,361

* Compiled from the Annual Reports of the Federal Reserve Board.

Expenses

The gross earnings of the Federal Reserve Bank were applied to operating expenses, charges for depreciation on buildings and reserve accounts, dividends, surplus, and the United States Government franchise tax. The cost of operating the New York Reserve Bank the first year (1914-1915) amounted to nearly \$300,000. The Bank began its work as fiscal agent and depository of the United States on January 1, 1916.⁴ These duties involved relatively little effort until the entry of the United States into the World War in April, 1917, and so it was decided that their cost be absorbed by the Bank. When the war-financing operations conducted by the Bank necessitated greatly increased expenditures in 1917 its total current expenses began to mount. But the Bank was reimbursed by the Treasury for practically all direct expenses incurred in carrying on those functions during the war period and until June 30, 1921. Since that date the Bank has been reimbursed for only those expenses incurred directly in connection with the sale of new issues of government securities.⁵

Another important factor in causing the large increase in current expenses during the war was the expansion of free services for member banks. Following the war the free services continued to show a substantial increase. These have been justified on the ground that they were a primary reason for the establishment of the Federal Reserve system. It was expected that the member banks would receive substantial benefits in the form of services rather than profits in return for the placing of their funds with the Federal Reserve banks. Such services they received in addition to the protection afforded them against financial panics or other emergencies. In 1920 the total expense for operations reached over \$6,000,000 and since then has assumed more or less constant proportions, having never fallen below that amount in any year.⁶ All of the expense items are relatively small in comparison with the amount paid in

⁴ Annual Report of the Federal Reserve Bank of New York, 1916, p. 21.

⁵ See Table 3, p. 113.

⁶ See Table 4, p. 114.

TABLE 3

FISCAL AGENCY EXPENSES OF THE FEDERAL RESERVE
BANK OF NEW YORK, 1917-1931 *

Year	Total	Reimbursable Expenses	Expenses Absorbed by F. R. Bank
1917	\$ 900,040	\$ 900,040	—
1918	4,821,309	4,821,309	—
1919	4,963,642	4,963,642	—
1920	1,516,455	1,516,455	—
1921	674,261	481,787	\$ 192,474
1922	605,812	209,289	396,523
1923	842,480	422,091	420,389
1924	315,315	48,469	266,846
1925	233,494	18,544	214,950
1926	189,339	15,190	174,149
1927	246,255	111,777	134,478
1928	189,983	88,809	101,174
1929	100,116	17,681	82,435
1930	90,766	20,158	70,608
1931	105,659	29,193	76,466
Total	15,794,926	13,664,434	2,130,492

* Source: Federal Reserve Board. Figures since 1931 were unavailable.

salaries. In 1931, for example, out of total current expenses of six and a half million dollars, approximately two-thirds was spent for salaries.

The volume of work which the Reserve Bank's staff performed bears little relation to the earnings. In 1923 the Bank reported that the personnel engaged in lending operations constituted only about 5 per cent of its entire staff.⁷ It is the cash and collection functions which are responsible for the major portion of the total expenses of operation.

Quite a substantial addition to current expenses before net earnings are determined is the depreciation allowed on the premises of the Reserve Bank. The purchase of a site and the erection of a building were authorized by the board of directors of the New York Reserve Bank in October, 1917.

⁷ Annual Report of the Federal Reserve Bank of New York, 1923, p. 13.

TABLE 4

TOTAL AND NET EARNINGS OF THE FEDERAL RESERVE BANK OF NEW YORK,
AND DISPOSITION MADE OF NET EARNINGS *

Year	Earnings and Expenses			Disposition of Net Earnings			
	Total Earnings	Current Expenses	Net Earnings	Dividends Paid	Transferred to Surplus	Franchise Tax Paid to United States Government	Profit (+) or Loss (-) Carried Forward
1914-15	\$ 345,035	\$ 468,922	\$ -123,887	—	—	—	\$ -123,887
1916	971,026	486,255	414,064	\$ 127,113	—	—	+286,951
1917	4,929,214	1,655,507	3,078,481	1,942,819	\$ 649,363	\$ 649,363	-163,064
1918	25,314,736	2,509,770	21,662,917	1,195,026	20,467,891	—	
1919	35,332,412	5,561,086	27,959,619	1,291,047	23,964,678	2,703,894	
1920	60,525,321	6,797,764	53,128,130	1,477,096	12,332,523	39,318,511	
1921	34,710,274	8,078,362	26,093,832	1,608,721	3,782,671	20,702,440	
1922	11,349,279	6,776,530	3,721,593	1,652,138	-1,397,603	3,467,058	
1923	11,413,183	6,880,136	3,043,679	1,749,239	129,444	1,164,996	
1924	8,569,350	6,350,821	616,852	1,796,530	-1,179,678		
1925	10,217,174	6,325,202	3,103,298	1,888,196	1,215,102		
1926	10,600,968	6,421,442	3,749,748	2,100,191	1,649,557		
1927	10,647,759	6,472,171	3,720,601	2,327,355	1,393,246		
1928	18,483,042	6,444,265	11,018,433	2,743,725	8,274,708		
1929	19,314,279	7,052,465	12,263,224	3,544,314	8,718,910		
1930	10,393,189	6,826,564	4,588,384	4,013,779	574,605		
1931	7,555,213	6,647,104	1,532,081	3,891,599	-2,359,518		
1932	15,948,943	6,376,729	10,404,550	3,562,030	6,842,520		
1933	17,523,930	7,052,351	6,197,727	3,509,873	2,687,854		
Total	314,144,327	105,183,446	196,173,326	40,420,791	87,746,273	68,006,262	

* Compiled from Annual Reports of the Federal Reserve Board.

In 1918 the Federal Reserve Board approved the purchase of a plot of ground in the financial district of New York City for the purpose.⁸ The war emergency and high costs for labor and materials delayed the construction until 1921. Up to that time the Bank had been quite handicapped on account of lack of safe and adequate quarters. It then occupied offices and vaults in six separate buildings.⁹ In that year charges of waste of public money and extravagance with regard to salaries and buildings of the Federal Reserve banks led an investigation of the same to be made by the United States Senate. The salaries and building program of the Federal Reserve Bank of New York were particularly the subject of attack but no action was taken on them by Congress as a result of the investigation.¹⁰

The new building was occupied by the Bank in 1924 and cost over \$14,000,000.¹¹ The cost of the building was not charged to current expenditures but was paid for out of the Bank's capital. Hence its cost did not reduce annual earnings and the Government was not deprived of franchise taxes because of it, except as depreciation or reserves were deducted under the rulings of the Federal Reserve Board. The Reserve banks may not hold real estate as an investment nor loan on real estate paper, except that they may own property necessary to their operations. Such assets being non-liquid, are inappropriate for the requirements of central banks. Even in the case of the Reserve bank buildings, the Federal Reserve Board adopted a ruling at the time they were being constructed requiring complete amortization by the end of fifty years.¹² Consequently, the New York Reserve Bank charges off each year 2 per cent of the cost of its building. The Bank is possessed of a building that is worthy of its responsibilities and central position in national and international finance and is admirably suited to its purposes now and for many years to come.

⁸ Annual Report of the Federal Reserve Board, 1918, p. 346.

⁹ Senate Document No. 75, 67th Congress, 1st Session, 1921.

¹⁰ *Idem*.

¹¹ Annual Report of the Federal Reserve Board, 1925, p. 122.

¹² W. P. G. Harding, *The Formative Period of the Federal Reserve System*, p. 250.

TABLE 5

TOTAL AND NET EARNINGS OF ALL FEDERAL RESERVE BANKS, AND
DISPOSITION MADE OF NET EARNINGS *

Year	Earnings and Expenses			Disposition of Net Earnings			
	Total Earnings	Current Expenses	Net Earnings	Dividends Paid	Transferred to Surplus	Franchise Tax Paid to United States Government	Profit (+) or Loss (-) Carried Forward
1914-15	\$ 2,173,252	\$ 2,320,586	\$ -141,459	\$ 217,463	—	—	\$ -358,922
1916	5,217,998	2,273,999	2,750,998	1,742,774	—	—	+1,008,224
1917	16,128,339	5,159,727	9,579,607	6,801,726	\$ 1,134,234	\$ 1,134,234	+509,413
1918	67,584,417	10,959,533	52,716,310	5,540,684	48,334,341	—	-1,158,715
1919	102,380,583	19,339,633	78,367,504	5,011,832	70,651,778	2,703,894	
1920	181,296,711	28,258,030	149,294,774	5,654,018	82,916,014	60,724,742	
1921	122,865,866	34,463,845	82,087,225	6,119,673	15,993,086	59,974,466	
1922	50,498,699	29,559,049	16,497,736	6,307,035	-659,904	10,850,605	
1923	50,708,566	29,764,173	12,711,286	6,552,717	2,545,513	3,613,056	
1924	38,340,449	28,431,126	3,718,180	6,682,496	-3,077,962	113,646	
1925	41,800,706	27,528,163	9,449,066	6,915,958	2,473,808	59,300	
1926	47,599,595	27,350,182	16,611,745	7,329,169	8,464,426	818,150	
1927	43,024,484	27,518,443	13,048,249	7,754,539	5,044,119	249,591	
1928	64,052,860	26,904,810	32,122,021	8,458,463	21,078,899	2,584,659	
1929	70,955,496	29,691,113	36,402,741	9,583,913	22,535,597	4,283,231	
1930	36,424,044	28,342,726	7,988,182	10,268,598	-2,297,724	17,308	
1931	29,701,279	27,040,664	2,972,066	10,029,760	-7,057,694	—	
1932	50,018,817	26,291,381	22,314,244	9,282,244	11,020,582	2,011,418	
1933	49,487,318	29,222,837	7,957,407	8,874,262	-916,855	†	
Total	1,070,259,479	440,420,020	556,447,882	129,127,324	278,182,258	149,138,300	

* Compiled from Annual Reports of the Federal Reserve Board. † Franchise tax requirement repealed by Banking Act of 1933.

Net Earnings and Dividends

After current expenses have been paid, and charges for depreciation on the buildings and reserves for various purposes set up, the balance constitutes net earnings available for distribution. It is evident that the Reserve Bank has a relatively large and more or less steady annual budget for operating expenses and overhead costs which it is called upon to meet in some way. Consequently, wide fluctuation in total earnings means considerable variability in net earnings.¹³ And this has been the situation during the course of the Bank's history. Thus, during the first year there were no net earnings, while in 1920 they amounted to \$53,000,000. If the years following 1921 be taken as perhaps affording a more settled picture, it is noted that net earnings have fluctuated widely between a low of \$600,000 in 1924 and a high of \$12,000,000 in 1929.

Disposition of net earnings is made according to law to three sharers—the member banks, the Reserve Bank itself, and the United States Government. The member banks have first claim upon them, being entitled to dividends amounting to 6 per cent of the capital stock of the Reserve Bank. The dividends are cumulative and in 1917 back dividends were paid covering the period when the Bank was getting started. Since 1917 the total dividend payments increased each year gradually until 1931.¹⁴ In case the net earnings are in any year insufficient to meet this claim the Bank's surplus is drawn upon to pay the dividends. Such withdrawals from surplus were necessary in three years, 1922, 1924, and 1931. In 1931 the dividend claims fell off owing to a decline in the number of member banks and a reduction of the capital stock of the Reserve Bank.¹⁵ But in spite of the decline in required dividends the net income was insufficient by over \$2,300,000 for meeting them in that year of the depression. Hence this sum was drawn from surplus for the purpose.¹⁶

¹³ See Table 4, p. 114.

¹⁴ *Idem.*

¹⁵ *Idem.*

¹⁶ Federal Reserve Bank of New York, 17th Annual Statement, Circular No. 1081, Jan. 22, 1932.

Surplus

The original Federal Reserve Act provided that after the dividend claims had been fully met, all the net earnings would be paid to the United States as a franchise tax, except that one-half of such net earnings would be paid into a surplus fund until it amounted to 40 per cent of the paid-in capital stock of a Reserve bank. The New York Reserve Bank was the first to accumulate this surplus of 40 per cent.¹⁷ And none of the other Reserve banks had accumulated the 40 per cent surplus before this requirement was raised.¹⁸ By an amendment, approved March 3, 1919, the terms of the distribution of earnings were changed by providing that the whole of such net earnings be paid into the surplus fund until it amounted to 100 per cent of the subscribed capital stock of the Reserve banks, and that thereafter 10 per cent of such net earnings be paid into the surplus.

The purpose of requiring the accumulation of a larger surplus was to secure better protection for the creditors of the Reserve banks and to increase their strength generally for their safety and the more effective carrying out of their functions.¹⁹ An adequate surplus is needed to permit a desirable divorcement between earnings and credit policy. The restrictions upon national banks concerning the liabilities they may incur are more strict than those imposed upon the Federal Reserve banks. National banks cannot legally become liable for borrowed money (except to Federal Reserve banks) in an amount greater than their capital stock, nor can they issue national bank notes in excess of this amount. In order to give essential elasticity to central bank operations, Federal Reserve banks were not made subject to these restrictions.²⁰

Furthermore, Federal Reserve notes, issued by the Federal Reserve Board through the Federal Reserve banks, are a

¹⁷ Annual Report of the Federal Reserve Board, 1918, p. 28.

¹⁸ *Idem.* For the percentage of surplus to capital attained by the other eleven Reserve banks see this reference.

¹⁹ Annual Report of the Federal Reserve Board, 1918, pp. 81-82.

²⁰ *Idem.*

liability of the Reserve banks and ultimately of the United States Government. It was considered, therefore, of much importance to the United States as well as to the Reserve banks that the surplus fund be increased. The deposit and note liabilities of the Reserve banks had increased beyond all original expectations on account of the war so that at that time (1918) the capital and surplus of the Reserve banks amounted to only 2 per cent of their total liabilities.²¹ In reporting upon the bill containing this amendment and urging its passage as requested by the Federal Reserve Board, it was stated that the New York Reserve Bank "has obligations greater than has the Bank of England, and yet the Bank of England has four times the capital of the Federal Reserve Bank of New York."²² For these reasons the higher surplus requirement provided a desirable soundness in the financial set-up of the Reserve banks.

The accumulation of a larger surplus fund under the 1919 amendment was provided for in three ways: 1. The base was higher, it being the *subscribed* capital stock instead of the *paid-in* capital stock, the former amounting to twice the sum of the latter. 2. The percentage was raised from 40 per cent to 100 per cent. 3. The surplus fund was not limited by the amount of the capital stock and percentage requirement but after the latter was met it could be enlarged without limit by the addition of 10 per cent of the net earnings. The amendment was made retroactive so far as the year 1918 was concerned. As a result of that year's operations over \$20,000,000 was transferred to surplus.²³ In 1919 an additional amount was transferred, so that by the end of the year the Bank was able to report a total surplus which not only surpassed the capital paid in but amounted to 100 per cent of the subscribed capital stock.²⁴ The surplus fund continued to be at least 100 per cent of the subscribed capital stock from 1919 to 1923 inclusive. At no time since 1919 has the surplus been less than the paid-in

²¹ Congressional Record, 65th Congress, 3rd Session, Vol. 57, Part 2, p. 1156, Jan. 9, 1919.

²² Statement of Senator Hitchcock, *idem*.

²³ See Table 4, p. 114.

²⁴ Annual Report of the Federal Reserve Board, 1919, p. 332.

capital. But since 1923 the surplus has declined relative to the subscribed capital. At the end of 1931 the surplus amounted to 171.0 per cent of the paid-in capital and only 85.5 per cent of the subscribed capital. In view of the fact that nearly two and one-half million dollars was withdrawn from the surplus at the conclusion of operations for 1931,²⁵ and since relatively large net earnings in the future are highly problematical, the larger surplus requirement of the Federal Reserve Act tends to provide a prudent strengthening of the financial position of the Reserve Bank.

Moreover, in the light of the experience of the depression period there is reason for believing that even after the 100 per cent surplus requirement is reached, a larger share of the net earnings of the Reserve banks should be retained than the 10 per cent which was allotted to them. For in so far as the Reserve banks accumulate a larger surplus fund in prosperous years, such strength tends to enable them to prosecute their central banking functions without regard to profit-making motives. To this end the Banking Act of 1933 provided that the Government is to receive none of the net earnings of a Federal Reserve bank but that all are to go into its surplus fund.²⁶ The recent period also emphasizes the need of elimination of waste and inefficiency in the operation of the Reserve Bank in every particular. The credit of the Reserve banks, their efficient management, and the carrying out of a sound policy require the accumulation of a relatively large surplus fund.

The Government's Share: Franchise Tax

Prior to the passage of the Banking Act of 1933, after the dividends had been paid and the surplus requirements fulfilled, all net earnings were to be paid to the United States Government. In only six years of the Bank's history has anything been paid to the Government. But in these years, 1917 and 1919-1923, the Government received \$68,000,000.²⁷ Such earnings could be used by the Secretary of the Treasury

²⁵ See Table 4, p. 114.

²⁶ Banking Act of 1933, section 4.

²⁷ See Table 4, p. 114.

to supplement the gold reserve held against outstanding United States notes or to reduce the outstanding bonded indebtedness of the United States. The Federal Reserve Act provided that the earnings receivable by the Government were to be paid by the Reserve banks as a "franchise tax." The justification for the tax was that the Federal Reserve banks were given a monopoly of note issue. It is true that national banks issue bank notes but they are not the so-called "asset currency" that Federal Reserve notes are or were originally intended to be. Furthermore, the intention of the Federal Reserve Act was that national bank notes were to be gradually retired from circulation. This is another of those things which was intended that has not occurred.

During the existence of the Federal Reserve system, the Government has received from all the Federal Reserve banks franchise taxes amounting to \$147,000,000. Of this amount the New York Reserve Bank has paid \$68,000,000.²⁸ Under the Aldrich-Vreeland Act, the Government taxed the members of the emergency currency associations upon the amount of "emergency notes" they issued at rates of 5 to 10 per cent. The New York Reserve Bank made a study of the taxes it would have paid if the Government had taxed it at a rate of 7 per cent on that portion of its Federal Reserve notes not covered by gold during 1920. The Bank found that the tax the Government would have received directly would have approximated very closely the amount it actually did receive as its share of the net earnings of the Bank for that year.²⁹

Under the Federal Reserve Act the Federal Reserve Board may charge the Reserve banks interest on the amount of their Federal Reserve notes outstanding which are uncovered by gold.³⁰ This interest could have been charged while at the same time the Government was not only a residual claimant to net earnings but actually received them. But such interest or franchise tax has never been

²⁸ *Idem*.

²⁹ Annual Report of the Federal Reserve Bank of New York, 1920, p. 24; Hearings before the Joint Commission of Agricultural Inquiry, 67th Congress, 1st Session, 1921, p. 719. (Hereafter cited as Hearings in the Agricultural Inquiry, 1921.)

³⁰ Federal Reserve Act, section 16.

levied by the Federal Reserve Board. Although the Government received no franchise tax in the form of net earnings from the New York Reserve Bank for any year since 1923 the Federal Reserve Board has not charged interest on the Federal Reserve notes it has issued to the New York Reserve Bank since that year.

In addition to the distribution of earnings the Bank has rendered valuable services for the Treasury.³¹ It was estimated that the Bank's expenses required on account of operations for the United States Treasury department were \$650,000 in 1925 and that in general they would run about \$600,000 a year.³² And this did not include the cost of certain services formerly rendered by the sub-treasury such as handling gold and currency. So far as the fiscal agency department's expenses are concerned, they are now largely absorbed by the Bank. Table 3, page 113, shows the relative amounts paid by the Treasury and absorbed by the Bank for the years stated. Beginning with 1917 and continuing until June 30, 1921, the Treasury reimbursed the Federal Reserve banks for practically all direct expenses incurred by them in the performance of their fiscal agency functions. Since the latter date the Reserve banks have been reimbursed for only those fiscal agency expenses which are incurred directly in connection with the sale of new issues of government securities, the cost of conducting all other fiscal agency operations and other government services being absorbed by the Reserve banks.³³ The major part of the Federal Reserve system operations for the Treasury have been handled by the New York Reserve Bank.³⁴

The fiscal agency expenses of the New York Reserve Bank have been greater proportionately than for the other Reserve banks. This is because the Treasury has dealt directly with this Bank, in effecting the distribution of its issues to all the Reserve banks, rather than with each Reserve bank separately.³⁵ The total fiscal agency expenses

³¹ See chapter X, pp. 214-215.

³² Stabilization Hearings on H. R. 7895, 1926, p. 488.

³³ *Ibid.*, p. 489.

³⁴ *Ibid.*, pp. 488-489.

³⁵ *Ibid.*, p. 278.

of the New York Reserve Bank from 1917 through 1931 comprised approximately 17 per cent of the current expenses of the Bank for that period. The benefit to the Government from the grant of a charter to the New York Reserve Bank cannot, therefore, be determined solely by the amount of the franchise tax received each year but consideration must be given to the services the Bank renders for the Government, the costs of which are borne by the Bank. In addition to receiving from the New York Reserve Bank almost half of the total amount of franchise taxes paid by all the Federal Reserve banks, the Government and the people of the United States have received no little benefit from the work performed for them by the Federal Reserve Bank of New York.

Effort to Reduce Government's Share and Increase That of Member Banks

The member banks generally have never been satisfied, during the entire existence of the Federal Reserve system, with the financial returns or services they have obtained as a result of their membership in the system. They have had the feeling that they were entitled to more than the limited return of 6 per cent on their paid-in capital stock. And so from the beginning they have constantly made an effort to get more out of the Reserve banks, to make the Federal Reserve system the means whereby they would make larger profits. In various ways they have succeeded in that effort by amendments to the Federal Reserve Act and through the administration of the Reserve system.

In other respects they did not succeed. Consequently the agitation to make the Federal Reserve more profitable to the member banks, especially by reducing the Government's share, continued. Various proposals were advanced and promoted. Most prominent among these have been:

1. Pay interest on member bank balances with the Federal Reserve banks.
2. Revise the allotment of net earnings so that the Government gets less and the member banks receive more, by
(a) leaving the fixed dividend rate as it is and paying all or

a larger share of the surplus earnings to the member banks, or (b) raising the fixed dividend rate above 6 per cent and basing it on the member banks' stock holdings, their reserve balances, or a combination of both. For the past decade a number of bills have been pending in Congress embodying variants of these proposals.³⁶

Paying Interest on Reserves

The plea of the banks for interest on their reserves in the Federal Reserve banks was based upon the fact that they customarily received interest on their balances in correspondent banks prior to the establishment of the Federal Reserve system. They also pointed out that state non-member banks in most states could satisfy part of their legal reserve requirements with correspondent bank balances which earned them interest. The Federal Reserve banks have not been permitted to pay interest on member bank balances for several reasons.

With due consideration to the claims of commercial banks under the old national banking system, and in order to be fair to them, the framers of the Federal Reserve Act, recognizing that a central bank could not properly pay interest on reserve balances, provided that the national banks should not lose the amount of interest on correspondent bank balances upon becoming members of the Federal Reserve system. They did this by lowering the legal reserve percentage required. This gave the banks power to create much more bank credit and so enhanced their earnings. It has been calculated that this reduction of legal reserve has more than offset any loss of interest on Federal Reserve bank balances. So the claim that national banks were losing interest on their reserves was not well taken because they

³⁶ Probably the most representative voice among banking interests supporting a reduction of the Government's share in earnings has been the Economic Policy Commission of the American Bankers Association. The view of this body may be found in its report of May 7, 1930. Another large organization, the Chamber of Commerce of the United States, has taken a stand in agreement with the bankers favoring a reduction of the Government's share. (See Report of its Banking and Currency Committee on the Federal Reserve System, December, 1929, pp. 22-25. See also Auxiliary Statements accompanying the committee report, December, 1929, pp. 121-124.)

were compensated for such loss at the start and again in 1917. But member banks have received still more than this compensation for the loss of interest. In the first place, by reason of the existence of the Reserve banks they have been enabled to make more loans and investments because they have been able to reduce relatively their idle vault reserves.

Under the Federal Reserve system banks have been able to get along with less cash on hand since it could be replenished quickly from the Reserve banks.³⁷ The Federal Reserve Bank of New York cited one of its members as an example.³⁸ The amount of cash which this bank kept on hand fluctuated widely on account of pay-roll requirements. Prior to membership in the system the bank was obliged to maintain vault reserves running as high as \$500,000 in order to avoid falling below the legal requirement for cash in vault of \$250,000. Their vault cash averaged about \$350,000. On the other hand, not long afterward, as a member bank it conducted its business with from \$125,000 to \$300,000 of vault cash which averaged about \$200,000. This member bank estimated that of a reserve balance of less than \$400,000 required at the Federal Reserve Bank, about half could be transferred from its vault and "therefore represented no loss of interest whatsoever." Upon the basis of the proportionately greater reserves which could be carried safely at the Reserve banks, the member banks built a superstructure of credit of many times that amount. Thus it is seen that the Federal Reserve system has made possible considerable profit for the member banks because of its ability to supply the banks with cash quickly.

Secondly, the member banks have been wont to call their reserves "idle" and to say that they fulfill no purpose other than meeting legal percentage requirements because they receive no interest on them directly. Reserves that make possible all the benefits to banks which flow from concentration and mobilization of reserves can hardly be called

³⁷ See Federal Reserve Bulletin, November, 1923, p. 1178.

³⁸ Federal Reserve Bank of New York, Questions and Answers, September, 1919.

idle or serving no purposes other than legal percentage requirements. Take for example, one use of reserves—their use as clearing accounts. The Federal Reserve banks handled, in 1931, over 864,000,000 checks totaling \$248,000,000,000. The bulk of these were deposited by the member banks which had reserve balances of only \$2,268,500,000³⁹ to take care of that large volume of checks cleared and at no expense to the member banks.

In the third place, through the more direct check collection system, funds become available and earnings begin more quickly than before the Federal Reserve system. Thus the member bank to which reference has just been made, estimated a considerable saving. It figured that it sent out daily about \$200,000 in checks and drafts and that by using the Federal Reserve system it received returns one day sooner than it did through former collection channels. Its saving was calculated as being equivalent to at least 2 per cent interest on \$200,000 and this was held to be a further offset to the loss of interest on its deposits with the Reserve Bank.⁴⁰

Another form of compensation has been the saving on shipments of cash between the member banks and the Reserve banks, which are made without cost to the former. Member banks have also benefited by a number of other free services. Still another offset is the gain they have made on their rediscounting operations since they have ordinarily borrowed from the Reserve banks at rates lower than those charged by the correspondent banks. Finally, though the reserves yield no interest directly and though the stockholders' share of the Reserve bank earnings is limited, yet, as a result of the centralization of reserves in the Federal Reserve banks, the member banks may make, as indeed they have made, substantial profits from loans extended on the basis of their borrowings from the Reserve banks or reserve balances credited to their accounts as a result of open market operations.

³⁹ Average reserve balance of all member banks on four call dates. Federal Reserve Board Report, 1931, p. 96.

⁴⁰ Federal Reserve Bank of New York, Questions and Answers, September, 1919.

As far as the state non-member banks getting interest on reserves carried in correspondent banks is concerned, Federal Reserve policy may not properly take cognizance of that. One of the purposes of the Federal Reserve banking reform measure was to get away from that very thing. Moreover, following the reduction of reserve percentages in the Federal Reserve Act, the states have commonly enacted less strict reserve requirements with a view to making the banking business more profitable for the state banks in competition with national banks. For the Federal Reserve to have still less strict reserve requirements with a view to outdoing the state banks would reduce Federal Reserve policy to an anomaly. It would mean the adoption of the business point of view whereas Federal Reserve policy should always be governed by the point of view of economics.

The Interest Paying Proposals and Central Banking Policy

Though member banks have been compensated for the loss of interest on bank balances which they formerly received from their correspondent banks, that is not the real reason why Federal Reserve banks have not paid and should not pay interest on member bank reserve accounts. Such compensation nullifies any possible charge to the effect that the banks have not been treated fairly in the matter but it does not touch the merits of the question at issue. The real reason involves the functions of central banks. In order to earn enough to pay interest on member bank balances the Reserve banks would be required to make huge profits compared to what they have been and are making.⁴¹ The forcing of such additional claims on income would mean that they would be compelled to give primary consideration to profit-making and go after more business. This would necessitate risks which a central bank is not justified in undertaking. Thus a profit-making policy would involve artificially low rates, extensive competition with member banks, and the reckless thrusting aside of the true objects of central banking policy. On the other hand the

⁴¹ Stabilization Hearings on H. R. 7895, 1926, p. 558.

payment of such interest would tend to induce member banks to borrow, stimulating unsound advances.

As a result of these considerations the reserves of the Federal Reserve banks would be dissipated and unavailable in time of need. Inflation in the financial and business organization and non-liquidity of Reserve bank assets would result. The reserve power to exert a stabilizing influence on business and financial conditions would be impaired. Thus it is seen that in order to be in a position to adopt a sound credit policy and make it an effective one, the Federal Reserve banks must be unhampered by profit-making motives.⁴² The question of whether the Reserve banks should pay interest on member bank reserves is one to be answered from the point of view of economics or national welfare, rather than from the standpoint of business or the commercial banks' desire for profit. And from this point of view it is seen that interest on commercial bank reserves would be incompatible with the central banking functions of the Reserve banks.

Reasons for Reducing Government's Share

It will be recalled that after the payment of an annual cumulative dividend of 6 per cent on the stockholdings of member banks and accretions to the surplus, all the remainder of the net earnings went to the Government prior to the enactment of the Banking Act of 1933. There had been much discussion about effecting a different distribution of earnings. Member banks favored a reduction or even an elimination of the Government's share but were not in agreement upon any particular plan for it.⁴³ For the most

⁴² It is assumed that some earnings will result from the regular course of their central banking operations. And such profits as are ancillary to their central banking functions are not in question in this analysis. During their history, the Reserve banks have made profits and in the ordinary course of events it will continue to be so. It is reasonable to expect this in view of the fact that the Reserve banks obtained their assets under no obligation other than a cumulative dividend of 6 per cent on the capital stock payments of member banks. None of the leading central banks pay interest on their deposits. (See Kisch and Elkin, *Central Banks*, 1932 Edition, pp. 142-143.)

⁴³ The payment of interest on reserves would reduce the Government's share, though indirectly. The discussion at this point involved a decrease in

part, the member banks, while seeking the surplus net earnings for themselves, did not openly oppose the payment of a portion of them to the Government. However, in the case of some of the bills which were introduced in Congress, this pressure for reducing the Government's share expressed itself in a form which allowed none of the earnings to the Government and all of them to the stockholders.

Those who supported the proposal to increase member bank earnings by reducing the Government's share argued that the member banks are entitled to the bulk of the residual earnings because they supply the funds which make those earnings possible. They contribute all the capital stock and furnish the bulk of the deposits. The deposits of the Government are comparatively small. Another point advanced was that the Reserve bank earnings are derived mainly from their operations with member banks. Furthermore, they could point to the considerable amount of services which the Reserve banks render the Government without charge and which they have been doing from 1921. The costs of the fiscal agency functions of the Reserve banks are now largely absorbed by these banks. Thus the fiscal agency expenditures of the Federal Reserve Bank of New York, 1921-1931, were \$3,500,000.⁴⁴ Of this amount, nearly two-thirds was absorbed by the Bank.

In addition, the Reserve banks' expenses are greater by reason of other services which they render the Government but which are not ordinarily regarded as fiscal agency functions. These are (1) services rendered as depositary for the Treasury, including the payment of government checks, warrants and coupons, the transfer of funds, and (2) currency and coin operations formerly performed by the United States Sub-Treasury. The substantial total amount expended on account of government services may be considered practically a part of the returns accruing to the Government in return for the privileges with which it has endowed the Reserve banks. And finally it was held that more generous

the percentage of earnings allotted to the Government and may be thought of as a reduction in the Government's share directly.

⁴⁴ See Table 3, p. 113.

distribution of earnings would increase the loyalty of member banks and tend to draw more banks into the system and hence strengthen it.⁴⁵ These points were also emphasized strongly by a committee of Reserve bank officers which reported to the joint conference of governors and Federal Reserve agents with the Federal Reserve Board in 1924.⁴⁶

Effect of Banking Act of 1933

The campaign for the payment of a larger share of net earnings to the member banks proved to be unsuccessful. The Banking Act of 1933 does not recognize the claims advanced for such a redistribution. A different apportionment of earnings, giving member banks an additional percentage dividend or share of earnings would bring about a tendency to inflation inasmuch as there would be the desire on the part of member banks for the Reserve banks to enlarge net earnings so that they would get more profits from the central banks. In so far as the Reserve banks would be under pressure to make earnings, this would result in an over-extension of Federal Reserve bank credit with a consequent weakening of their reserves. Thus they would be going contrary to their function as central banks which are expected to build up reserves when possible and conserve them at all times. Refusal to increase the allotment to member banks tends to prevent the Reserve bank directors from adopting unsound credit policies with a view to profit-making. Hence the limitation of shareholders' profits to a minimum return on the capital investment is because central banking policy is incompatible with the desire of shareholders for increased profits and enlargement of Federal Reserve bank earnings.

Furthermore, the requirement in the new Act that after the 6 per cent dividend claims have been fully met, "the net earnings shall be paid into the surplus fund of the Federal Reserve bank" will tend to increase the strength and efficiency of the Reserve banks. Their future earnings are un-

⁴⁵ Report of Economic Policy Commission, American Bankers Association, May 7, 1930, p. 12.

⁴⁶ See below, p. 133.

certain. They may be nominal or there may be losses. To take care of such in any year the present provision for the distribution of earnings is so framed as to guard against the adoption of an inflationary credit policy. The new Act increases the possibility of building up a competent surplus and this surplus makes possible the adoption of a central banking policy mainly irrespective of expenses, losses, or profits. The need for a competent surplus, therefore, is another reason for limiting dividends on Reserve bank stock.

Returns to the Government

The campaign for a reduction of the Government's share did, however, result successfully. The reason why the Federal Reserve Act provided that part of the net earnings of the Reserve banks were to be paid to the Government is this: The Government has granted them the distinct and profitable right of issuing paper money and creating bank deposit credit based upon their holding the legal, ultimate gold reserves of the money and banking system. Such a right involved considerations of broad and fundamental social concern and in return therefor the Government is entitled to a part of the profits of the Reserve banks. The share of net earnings to the Government was viewed as a payment for a right conferred, a kind of franchise tax, resting upon considerations of public policy. Another reason for a return to the Government is that it stands behind the Reserve banks' liability for their Federal Reserve notes, in that the Government is ultimately itself liable for the redemption of these bank notes in gold. Under the Banking Act of 1933, however, the Government will receive no more of the net earnings of the Reserve banks.

Although no share of the profits of our central banks is now distributed to the Government, it may secure a return from the franchise it has granted the Federal Reserve banks in ways other than by receiving a share of net earnings. As stated above, in the first place, the Government has benefited by a number of free services rendered it by the Reserve banks in lieu of monetary returns. Another form of franchise tax is a tax on the note issue. The Federal Reserve Act

authorized the Federal Reserve Board to require the Reserve banks to pay interest on the amount of their Federal Reserve notes outstanding uncovered by gold. But the Federal Reserve banks have paid the Government no interest, or tax, on these bank notes, the Board not having required them to do so. Any allotment of earnings which the Government formerly received, may, therefore, be looked upon as being in some portion in lieu of this tax on Federal Reserve notes.

The plan of taxing Federal Reserve notes not covered by gold has been officially discussed. In June, 1920, the Federal Reserve Board advised the Reserve banks that they were considering imposing the interest charge.⁴⁷ The Board referred to the criticisms at that time against the large earnings of the Federal Reserve banks and to the fact that it was generally overlooked that the large earnings of the Reserve banks are due to a great extent to their use of Federal Reserve notes.⁴⁸ The opinion of the Federal Reserve Board, however, was divided and no action was taken on the matter. It finally decided not to impose the tax because it "did not want to seem to be doing anything to restrict the circulation the business of the country demanded."⁴⁹

In discussing the subject before the House Banking and Currency Committee, Governor Harding held that a specific tax on the uncovered portion of the note issue would result in relatively large returns to the Government when the Reserve banks had large earnings because the latter were due to a considerable extent to the issue of Federal Reserve notes; while on the other hand in lean years the Government would receive little or nothing as a result of the tax.⁵⁰ The taxing of Federal Reserve notes was considered as an alternative to the former plan of government participation

⁴⁷ Report of Committee to Consider Advantages of Tax on Circulation over Government Participation in Profits, 1924.

⁴⁸ *Idem*.

⁴⁹ Hearings on Distribution of Profits of Federal Reserve Banks before the House Committee on Banking and Currency, June 28, 1922, p. 6.

⁵⁰ *Idem*. These hearings were on H. R. 12208, a bill which provided that excess earnings, after allotting 10 per cent to surplus, be divided equally between the Government and the member banks.

in profits also by a Federal Reserve committee. The conclusions of the committee were (1) that the Federal Reserve Board should tax the uncovered portion of the Federal Reserve notes outstanding and (2) the Reserve bank earnings in excess of accretions to surplus should be divided between the Government and the member banks "in either a fifty-fifty or a sixty-forty proportion, the division among the member banks being made in proportion to the average reserve balances maintained."⁵¹ Nothing came of these recommendations.

⁵¹ Report of Committee to Consider Advantages of Tax on Circulation over Government Participation in Profits, submitted to the conference of governors and Federal Reserve agents with the Federal Reserve Board, 1924, by George W. Norris, governor, Federal Reserve Bank of Philadelphia and J. H. Case, deputy governor, Federal Reserve Bank of New York. See above, pp. 123-124.

CHAPTER VII

OBSTACLES TO DEVELOPMENT AND MEMBERSHIP

Antipathy of the Bankers

The Federal Reserve Bank of New York began its existence under circumstances of adverse nature. The World War had created numerous problems requiring the attention of the Federal Reserve Board and not as much consideration could be given to the development of the Federal Reserve system as would otherwise have been the case. The Aldrich-Vreeland emergency currency, the issue of which began immediately after the advent of the World War in the summer of 1914, involved problems of retirement along with the formulation of Federal Reserve policy. The controversy which had developed during the progress of the Federal Reserve Act in Congress between the bankers and those sponsoring the Act made the process of developing the Reserve banks subject to difficulties.

The efforts to obstruct the Reserve Bank itself began with the effort to put off its opening indefinitely which was discussed in chapter IV. The Federal Reserve system was unique in that for the most part those who were entrusted with the responsibilities of carrying out the provisions of the Federal Reserve Act and managing the Federal Reserve banks had opposed the establishment of the central banking system provided by the Act. The activities of the Governors Council ¹ during the early years of the system interfered with the process of developing the Reserve banks inasmuch as it was an unauthorized body and its efforts included not only interference with but even defiance of the legally constituted powers and orders of the Federal Reserve Board.²

¹ See chapter V, p. 102.

² Willis, *The Federal Reserve System*, pp. 706-707.

The New York Reserve Bank had as its first governor one who had opposed the passage of the Federal Reserve Act.³

Practically none of the banks in the district were sympathetic with the new banking system. The large New York City banks assailed the Federal Reserve system because it threatened their correspondent banking business. The out-of-town banks were fearful lest they would lose the profits derived from their exchange charges. One of the large New York City banks refused to turn over its gold in payment of its subscription on its capital stock when such payment was due on November 2, 1914, and withheld it for some time thereafter. The Reserve Bank did scarcely any rediscounting in its early days. The New York bankers were generally opposed to it. At the beginning of the Reserve Bank's operations the bankers said that member banks in New York City would continue to do most of the rediscounting for the country banks⁴ and they did so.⁵ And under the conditions then existing the New York banks did not have occasion to do much rediscounting themselves. The reduction in reserve requirements under the Federal Reserve Act had made available to the member banks much more lending power.

The national banks, which in a sense entered the Federal Reserve system involuntarily, were unfriendly to the central banking system. They talked persistently against the system.⁶ They looked upon the Federal Reserve Bank not only as an unprofitable venture for them but as an unnecessary expense.⁷ The smaller banks in the district, as well as the large New York City banks, were apathetic and hostile to the system and in keeping with this attitude most of the member bank reserve accounts were dormant.⁸ One banker in a small town in Putnam County, New York, in 1915, charged off as a loss the amount of his bank's subscription to the capital stock of the Federal Reserve Bank of New

³ Stabilization Hearings on H. R. 7895, 1926, p. 341.

⁴ The New York Times, Nov. 18, 1914.

⁵ Annual Report of the Federal Reserve Bank of New York, 1915, p. 35.

⁶ The Commercial and Financial Chronicle, May 29, 1915, p. 1791.

⁷ Idem; Annual Report of the Federal Reserve Bank of New York, 1915, p. 35.

⁸ Annual Report of the Federal Reserve Bank of New York, 1915, p. 35.

York because he doubted that the Reserve Bank would ever pay a dividend on it.⁹

While some bankers doubted that the Bank would be successful enough to pay dividends, others were fearful that it would enlarge its loan and investment operations and deprive them of business. As a result efforts were made to have the Reserve Bank's capital returned to the stockholders and a bill was introduced in Congress early in 1916 providing for the cancellation of the unpaid subscriptions to the capital stock and the return to the member banks of most of that already paid the Reserve banks.¹⁰ But these efforts were frustrated. A number of member banks sent anonymous letters to the New York Reserve Bank. They contained extracts from section 9 of the Federal Reserve Act, entitled "Failure to comply with Regulations," with certain words underlined. The Reserve Bank officials presumed that the letters were sent for the purpose of creating prejudice against the Federal Reserve system.¹¹

Rival Plans for a Central Bank

The old attitude of hostility to the Federal Reserve continued on the part of a substantial number of bankers and became so pronounced that it brought forth some rival plans. During the latter part of 1914 it was announced that a plan, which had been under consideration for some time, had been proposed to establish a central banking institution for the State of New York to be a rival of the Federal Reserve Bank of New York. Capital was to be supplied by the New York State banking institutions and the proposed bank was to hold their reserves. The bank was to perform functions similar to those authorized for the Federal Reserve banks. It was suggested that this bank might be a rival not only of the Federal Reserve Bank of New York but of all the Federal Reserve banks, because the proposed

⁹ American Bankers Association Journal, May, 1927, p. 801.

¹⁰ The Commercial and Financial Chronicle, Sept. 18, 1915, p. 888; April 8, 1916, p. 1309.

¹¹ Letter from Federal Reserve Bank of New York to member banks, June 28, 1916.

bank would hold out the offer of rediscounting facilities not only to banks in New York State but to banks all over the country and on more attractive terms than the Federal Reserve could offer.¹² This plan, however, was not carried out.

Another effort of similar type was undertaken. But this time it was by a bank already organized with a successful record behind it. For some years some of the larger New York banks had had ambitions to become central banks themselves.¹³ A definite effort in this direction was undertaken by the Guaranty Trust Company of New York. When, in the spring of 1915, the Federal Reserve Bank of New York announced the plan for the collection of checks on member banks at par, the Guaranty Trust Company solicited the non-member banks, in the State of New York especially, to utilize their bank for clearing and collection purposes.

In a letter to the banks the Guaranty Trust Company made the proposal that the banks maintain reserves with the Guaranty Trust Company which would collect their checks free of charge.¹⁴ This bank offered to non-member banks in the State of New York the right to print or stamp on all of their checks the words, "Collectible at par through the Guaranty Trust Company of New York"; and while the Reserve Bank did not pay interest on reserve balances the Guaranty Trust Company offered to pay 2 per cent. This plan of the Guaranty Trust Company failed to assume substantial proportions beyond what was accomplished by the larger New York banks as correspondent banking institutions.

Conflict between the Reserve Bank and the New York Clearing House

One of the most serious obstacles to the development of the New York Reserve Bank was the effort of the New York

¹² The Financial Age, Dec. 19, 1914, p. 1100.

¹³ Willis, The Federal Reserve System, p. 562.

¹⁴ The Commercial and Financial Chronicle, April 24, 1915, p. 1407. The letter is printed in full. The voluntary intra-district collection system of the New York Reserve Bank was announced April 20, 1915. The letter of the Guaranty Trust Company to the banks was dated April 3, 1915, but it was not given out until after the Reserve Bank's circular (No. 22) was released.

City banks through their clearing house association to combat the spread of the clearing and collection system of the Reserve Bank. On June 1, 1915, the voluntary intra-district collection system of the Reserve Bank became effective.¹⁵ The commercial banks countered by establishing an out-of-town check collection department in the New York Clearing House which began to function on August 9, 1915.¹⁶ There were, then, three systems in the field in New York City for the out-of-town check collection business in its territory.

It was seriously proposed at the time that these three systems continue, as if such a plan could be successful, and it is interesting to note the basis upon which the field was divided up among them. Thus said *The Financial Age*:

With the installation of the new department,¹⁷ New York will have a transit system equal, if not superior, to any in the country. The Federal Reserve Bank of New York, with its control of foreign exchange and administration of rediscounts, will be the international clearing house. The private system maintained by the largest of the metropolitan trust companies will clear for state banks and trust companies which are not members of the Federal Reserve system. The Clearing House, finally, will collect for its members, free of charge, all out-of-town checks drawn on banks agreeing to remit upon presentation of mail items.¹⁸

The regulations adopted by the New York Clearing House Association provided for the collection of checks on all banks in the five states of New York, New Jersey, Connecticut, Massachusetts, and Rhode Island which agreed to remit at

¹⁵ Annual Report of the Federal Reserve Bank of New York, 1915, p. 24. Regarding this move of the New York Clearing House Association, *The Financial Age* said: "New York City had horse-drawn street cars years after the small towns of the country had installed electric cars, but New York ultimately adopted the electric way. Now, spurred on by the competition of the Federal Reserve Bank, the New York Clearing House Association, has, after weary years of agitation, installed a department to serve as a collection agency for country checks deposited with its members." *The Financial Age*, July 24, 1915, p. 96.

¹⁶ Annual Report of the Federal Reserve Bank of New York, 1915, p. 25.

¹⁷ In reference to the new out-of-town check collection department of the New York Clearing House.

¹⁸ *The Financial Age*, July 24, 1915, p. 96.

par by draft on New York Clearing House banks or cash on the day of the receipt of any items sent them. The Clearing House of London had established a country clearing department in 1858 for the purpose of clearing checks in England and Wales. In several cities in the United States, during the latter part of the last century, there had been established out-of-town collection departments in their clearing houses.¹⁹ That of Boston was especially noteworthy. The New York Clearing House had not established such a department.

When the Federal Reserve system inaugurated its par collection plan for out-of-town checks, the New York City banks did not let the plan of the Federal Reserve develop normally or efficiently. Instead they set up an out-of-town clearing department in their own association to do what the Federal Reserve system had already set up the machinery for doing. There was thus brought about an obstruction to the purpose and functioning of the Federal Reserve system. The establishment of that out-of-town collection department in the New York Clearing House, while in operation, rendered ineffective the accomplishment of the purposes of the Federal Reserve Act as regards the elimination of the clearing and collection evils of the national banking system.

In Boston the clearing house association of that city turned over its work to the Federal Reserve Bank of Boston. When compulsory collection was introduced by the Federal Reserve system in July, 1916, the Boston Reserve Bank took over the entire equipment and staff of the Boston Clearing House.²⁰ The Boston Reserve Bank then did the clearing of checks not only on the Boston banks but on all banks in New England as well as on banks in other Federal Reserve districts. In New York City, however, the New York Clearing House banks were not agreeable to such a course.

During these first years of the Reserve Bank's development, competition between the Clearing House and the Federal Reserve system regarding this matter was keen. It was a question whether the Federal Reserve Bank of New York would have to yield to the New York Clearing House

¹⁹ W. E. Spahr, *The Clearing and Collection of Checks*, pp. 124-130.

²⁰ Annual Report of the Federal Reserve Bank of Boston, 1916.

on this collection problem or the New York Clearing House would yield to the Federal Reserve. The New York Clearing House system for the collection of out-of-town checks comprised 347 members at the outset in August, 1915. By the end of 1915 it had over 500 members and the volume of its transactions was about twice as large as that of the collection system of the Reserve Bank.²¹ It then announced an extension of its plan involving the five states above in that it would receive items on any banks joining its system in places from which mail reached New York overnight.²²

In the course of development of the central banking organization, however, it turned out that the effort of the New York Clearing House was withdrawn. The inauguration of compulsory par collection by the Federal Reserve Board in 1916, provided a basis for the success of the Federal Reserve Bank's collection system. The establishment of the compulsory system was followed by reductions of the charges which New York Clearing House banks imposed upon their customers for the collection of out-of-town checks. The Reserve Bank's service charge of one cent per item for collecting checks and cash items was eliminated in June, 1918.²³ Another factor responsible for the supremacy of the Reserve Bank was the increase in the number of banks throughout the United States on which checks could be collected by the Federal Reserve banks at par.²⁴ Finally, the New York Clearing House adopted an amendment to its constitution, effective October 1, 1918, providing that its members should neither pay a higher charge for the collection of checks on banks on the Federal Reserve par list than would be incurred in collecting such items through the Federal Reserve Bank, nor allow the paying bank to hold back the remittance beyond the day on which the item is received.²⁵

The result of the change in the constitution of the New York Clearing House was to make it advantageous to mem-

²¹ Annual Report of the Federal Reserve Bank of New York, 1915, p. 25.

²² *Idem*.

²³ Annual Report of the Federal Reserve Board, 1918, p. 331.

²⁴ *Idem*.

²⁵ *Idem*.

bers of the association to send to the Reserve Bank their out-of-town items on banks which were on its par list.²⁶ The Clearing House continued its out-of-town collection department but a short time after the new regulation went into effect—until November 15, 1918, when it was abandoned and its work was taken over by the Federal Reserve Bank.²⁷ With the removal of this obstacle the New York Reserve Bank greatly increased the efficiency of its clearing and collection functions and they assumed a degree of effectiveness more nearly in accord with the purposes of a clearance institution.

Opposition to Clearing and Collection Functions

The objections of both member and non-member banks at every point in the development of the par collection system constituted difficulties which the Federal Reserve authorities had to overcome. When the voluntary intra-district collection system was introduced June 1, 1915, only 70 member banks in the district joined it. There were two primary reasons why more of them did not join.²⁸ First, the banks had been accustomed to deducting exchange when remitting for items drawn upon them and to join the Federal Reserve par collection system meant that they would have to forego this source of profit. Second, the system necessitated their keeping larger reserves at the Reserve Bank and hence loss of interest in order to avoid impairment of reserves resulting from the practice of the Reserve Bank of charging directly against the account of the paying bank.

The fact that so few banks joined the collection system accentuated this impairment of reserves because the checks against them could not be offset as much as would have been the case had a larger number joined. Hence the impairment of reserves resulting from the introduction of this voluntary collection system was both a cause and effect of the smallness of the number of member banks which did join. State banks were reluctant to join the Federal Re-

²⁶ *Idem*.

²⁷ Annual Report of the Federal Reserve Bank of New York, 1918, p. 21.

²⁸ Annual Report of the Federal Reserve Bank of New York, 1915, p. 24.

serve system for these reasons as well as for others.²⁹ This factor, therefore, cut down the number of banks which could be members of the voluntary collection system. When the Federal Reserve Board ordered the inauguration of the compulsory par collection system³⁰ on July 15, 1916, protests by the banks were vigorous and widespread.

When this step was under consideration the members of Group VI of the New York State Bankers Association, in convention assembled, passed a resolution urging amendments to the Federal Reserve Act repealing the provisions on the collection of checks and ending further transfer of reserves to the Federal Reserve banks.³¹ Later on in response to a request from the Reserve Bank³² the up-state bankers resolved not to sign an agreement calling for par collection of checks on non-member banks.³³ In order to secure payment for checks at par the New York Reserve Bank finally was obliged to resort to the presentation of them by express company or other local agents at the counters of a number of paying banks. The introduction of various other Federal Reserve services all met the same obstruction from the larger city banks whenever those services were believed to reduce their province as correspondent banks.³⁴

During all of this period the Federal Reserve Board was determined to carry out the provisions of the Federal Reserve Act and proceeded to develop the new powers and functions of the Reserve banks with as much dispatch as possible. Stimulated by the efforts of the Federal Reserve Board, officers Pierre Jay and Benjamin Strong of the Reserve Bank aided materially in effecting the firm establishment of the new banking system. By explanation of the aims of the Federal Reserve clearing and collection pro-

²⁹ See below, pp. 144-146.

³⁰ The Commercial and Financial Chronicle, Feb. 19, 1916, p. 656.

³¹ Circular No. 1 (Series of 1916), Federal Reserve Board, May 1, 1916.

³² Circular, Federal Reserve Bank of New York, April 1, 1916.

³³ The Commercial and Financial Chronicle, April 7, 1916, p. 1344.

³⁴ Regarding obstacles to development of the Federal Reserve, see also Willis, The Federal Reserve System, pp. 660-663 and chapters XXXVII and XXXVIII.

gram, the benefits to be derived from it and from membership in the system, and by earnest, patient solicitation, Messrs. Jay and Strong secured the coöperation of an ever increasing number of member and non-member banks.

The Membership Problem

During the process of formulating the Federal Reserve Act, it was urged that national bank membership in the system be made voluntary. This proposal, however, was rejected as being impractical, because of the danger that the central banking system could not be established in that way on account of the refusal of banks voluntarily to enter the system. Compulsory membership for all national banks was therefore imposed. The difficulties later encountered in securing the coöperation of the banks in establishing the system evidenced the wisdom of this decision. The Federal Reserve Act as finally enacted provided for the voluntary admission of state banks and trust companies to membership in the system.

The problem of the admission of state banks to membership was one which had been considered by the Reserve Board practically from the opening of the central banks.³⁵ A unified banking system in the United States was urged by the Board during its first year. The central Board set forth its views and inaugurated the system's effort to include the state banks in June, 1915. The following is quoted from the Board's statement:³⁶

A unified banking system, embracing in its membership the well-managed banks of the country, small and large, state and national, is the aim of the Federal Reserve Act. There can be but one American credit system of nation-wide extent, and it will fall short of satisfying the business judgment and expectation of the country and fail of attaining its full potentialities if it rests upon an incomplete foundation and leaves out of its membership any considerable part of the banking strength of the country.

The original attitude of the state institutions, however, was one of aloofness. In that formative period, prior to the

³⁵ Federal Reserve Bulletin, July 1, 1915, p. 117.

³⁶ *Ibid.*, p. 145.

entrance of the United States into the World War, the state banks generally preferred not to join the system until benefits accruing to them from membership were apparent and the effects of the operation of the system became manifest.³⁷ The banking requirements under the state laws of New York, New Jersey, and Connecticut, the states included in the Second Federal Reserve District, were less strict than those imposed by the Federal Reserve Act. The central banking act had not been on the statute books four months before New York State passed a banking act devised to offset any net advantage which the Federal Act may have offered to state institutions joining the central banking system.³⁸ The New York law sought to make it more attractive to state institutions to remain outside the Federal Reserve system. This new statute not only extended to state institutions some advantages which they would have gained by entering the Federal Reserve system, but gave some privileges which would have been sacrificed if they had joined the Federal Reserve.³⁹

Furthermore, the state institutions feared membership would involve double reports and examination and double governmental regulation and control. They also feared the authority of the Federal Reserve Board and their attitude was expressed in the words of one banker who said "we do not want them to come in and tell us how we shall run our business."⁴⁰ They also wished to see how the national banks fared under the new system before joining. This attitude was intensified by the feeling that, once in, they could not withdraw from membership as easily as could a national

³⁷ Annual Report of the Federal Reserve Board, 1914, p. 20; Annual Report of the Federal Reserve Bank of New York, 1915, p. 37; *The Financial Age*, May 23, 1914, p. 892; *The New York Times*, July 10, 1914, p. 2; *The Commercial and Financial Chronicle*, May 1, 1915, p. 1479; *The Financial Age Supplement*, July 3, 1915, p. 1135. See Table 6, p. 158. Consult also Willis, *The Federal Reserve System*, chapter XXXVII.

³⁸ The Report of the Federal Reserve Committee on Branch, Group and Chain Banking, as yet unpublished, contains a detailed treatment of the competition between national and state banks in the United States and its ill effects.

³⁹ *The New York Times*, April 19, 1914, Section IX, p. 11.

⁴⁰ E. C. MacDougal, president, Bank of Buffalo, address before New York State Bankers Association, Saratoga Springs, N. Y., June 24, 1915: *Financial Age Supplement*, July 3, 1915, p. 1135.

bank. In an address before the New York State Bankers Association in the summer of 1915, the governor of the New York Reserve Bank pointed out three objections which state bankers had to membership.⁴¹

1. The elimination of the "padded" reserves practice.
2. The possible duplication of reserves, or necessity for excess reserve balances, for collection purposes.
3. The loss of revenue from exchange charges.

It may be asked why a state bank should keep duplicate reserves with its correspondent bank after joining the system. In answer to this Mr. Strong pointed out that a bank felt it must continue to carry balances, which drew 2 per cent interest, with its old correspondent in order to have the following services performed: ⁴²

1. The collection of all checks drawn on non-member banks and on points outside of the district, which the Reserve Bank is not now able to handle.
2. The checking, purchase, and collection of commercial paper.
3. Investigation, purchase, custody, and sale of bonds.
4. Making general inquiry regarding banks and other credits.
5. Loaning surplus funds on collateral security on the New York Stock Exchange.
6. The collection of notes.

Early in 1916, the chairman of the New York Reserve Bank stated that there were four major reasons which kept state banks in the district from joining the system.⁴³ They were:

1. The failure of the Reserve Bank, as yet, to pay dividends.
2. The certain loss of interest on reserve deposits.

⁴¹ The Financial Age Supplement, July 3, 1915, p. 1123, address of Benjamin Strong.

⁴² The Financial Age Supplement, July 3, 1915, p. 1135.

⁴³ Address of Pierre Jay at Watertown, N. Y., April 17, 1916, on "The Country Banker and the Federal Reserve System."

3. The adjustments made necessary by the development of the collection system.

4. The probable loss of the revenue many country banks now secure by deducting exchange when remitting for checks drawn upon them.

During the pre-war period, the officers of the New York Reserve Bank and members of the Federal Reserve Board were engaged in "missionary" efforts among the state institutions. By holding conferences with them, by writing, and by addressing various gatherings, they endeavored to answer their reasons for not joining surveyed above and to convert the non-member banks to membership in the system. So far as obtaining immediate results was concerned their efforts were practically in vain.

When the Federal Reserve Bank of New York opened in November, 1914, it had no state institutions as members. In 1915 only one such joined, and up to August, 1917, there was only one more. It is of interest, therefore, to note the ideas which actuated these two banks in joining and thus "breaking new ground" in adopting a policy quite at variance with that of the state institutions. The Broadway Trust Company, New York City, was the first state institution to become a member bank, joining the system in the summer of 1915. At that time its president said:

To be sure, our State Bank laws as regards trust companies provide for lower reserves, the reserve law requiring 3% higher reserves (18%) and all of it, ultimately, in cash or on deposit with the Reserve Bank without interest. I doubt, however, that many state banks or trust companies will feel comfortable standing alone on their own feet with lower reserves than the national banks which have the Reserve Bank to lean against. Besides, the reports of state institutions show that they have uniformly declined to avail themselves of the lower reserve privilege.

As a member bank, the acceptance provision will be restricted, inasmuch as the total amount outstanding will be limited to one-half of the capital and surplus, or with special permission, to 100% of such amount. While, perhaps, it may be argued that this is too low a limit, if there is any virtue at all in restrictive legislation concerning bank commitments, our present State law, in my opinion, allows too much latitude in this respect. I do not understand, from reading the Reserve Law, that a state bank

may not make domestic acceptances as well as foreign, if the total be within the lawful limit, but in any event, at the present time and with our present business customs, domestic acceptances are of no great help.

The question of real estate loans is left rather open, the provision being to the effect that they must not be made to such an extent as to render the assets of the institution unduly non-liquid, that is, beyond the point of safety. This surely jibes with common sense, and any institution which will base its refusal to join the system on this account will present a dubious argument. In the case of trust companies, their capital stock is by law non-liquid, and may not even be kept in gold dollars in its vault, but must be permanently tied up in certain high-class bonds or mortgages. This gives them a capacity for loans on real estate which, in my opinion, should be sufficient, as I cannot agree that it is good sense to loan deposits which are repayable on demand, in non-liquid securities of this kind.

The one objection which seems at this time to be well founded is concerning the attractiveness of the capital stock of the Federal Reserve Bank as an investment. I have always regretted that the dividend was made cumulative. The New York Federal Reserve Bank is not at present earning its dividend of 6%, but its organization expenses have been heavy, and it has so far invested only about 10% of its assets. I am told that if 20% were invested, even at present low rates, its dividend would be covered, as is already the case in other of the Reserve banks, where the demand has been heavier, that is, Atlanta, Dallas, and Richmond. It seems likely that these latter banks will before long be coming to the New York Bank for rediscounts, in which case the dividend will be in sight.

It is hardly necessary to mention the principal great benefit of membership to member banks and their customers. This is the right of such member banks to convert, through the Reserve banks, their commercial assets into cash or credit. It seems to me that if this right is not appreciated by the state institutions, it will be by their customers.

My own feeling has been from the start that the Broadway Trust Company should join the system, as its banking business is practically all commercial and its assets of the character which are acceptable under the Reserve Bank Law.⁴⁴

In the summer of 1916, a second state institution became a member bank. This was the Corn Exchange Bank of

⁴⁴ F. G. Lee, quoted in *The Commercial and Financial Chronicle*, June 12, 1915, p. 1979.

New York which is still a member of the system. It issued the following statement:

This bank has applied for admission to the Federal Reserve system and we have been admitted upon terms which we consider favorable. Our status as a State bank is maintained with all the principal privileges we now enjoy.

Whatever feeling of disapproval and distrust of the system we may have had has been put aside in the larger view that the Federal Reserve system has come to stay, and it becomes a duty not to oppose it, but to coöperate to its improvement.

This we believe can best be done by a full membership, and our motive in joining is to contribute our share to its resources and to associate ourselves with other leading banks of the country in developing the system.

We have been pleased with the courtesy and coöperation with which we have been met by the Federal Reserve Board and the Federal Reserve Bank of this district.⁴⁵

Efforts to Increase Membership during the War

The entrance of America into the World War furnished a powerful stimulus to the efforts to enlist state banks as members. Among those who took a prominent part in this campaign were: officials of the United States Government, officials of the Federal Reserve system, the Council of National Defense, State Councils of Defense, the American Bankers Association, the New York Superintendent of Banks, and the President of the Association of State Banks of the State of New York. Much of the membership campaign effort was based upon an appeal to patriotism and often assumed a war-like color. Typical of such are the following:

William G. McAdoo, Secretary of the Treasury said:

The time may come when the financial resources of the country will not be commensurate with the national purpose, if the nation remains half state bank and half national bank in its organization. The state banks will find greater security for themselves, if disaster should threaten, if they are members of the Federal Reserve system; and the Federal Reserve system itself will be irresistibly strong if the state banks unite with the national banks in making them an extremely useful national instru-

⁴⁵ The Commercial and Financial Chronicle, July 8, 1916, p. 107.

ment. I commend this question to your earnest and patriotic consideration, with the sincere hope that love of our common country should surmount every other consideration, and bring about this supremely desirable result.⁴⁶

President Wilson issued a statement October 13, 1917, which was sent by the Federal Reserve Board to all banks urging immediate consideration. The President said:

May I not, therefore, urge upon the officers and directors of all non-member state banks and trust companies which have the required amount of capital and surplus to make them eligible for membership, to unite with the Federal Reserve system now and thereby contribute their share to the consolidated gold reserves of the country? I feel sure that as member banks they will aid to a greater degree than is possible otherwise in promoting the national welfare, and that at the same time, by securing for themselves the advantages offered by the Federal Reserve system, they will best serve their own interest and the interest of their customers. I believe that coöperation on the part of the banks is a patriotic duty at this time, and that membership in the Federal Reserve system is a distinct and significant evidence of patriotism.⁴⁷

An officer of the Federal Reserve Bank of New York set forth in a letter the following argument:

The Federal Reserve Act has now been amended in such a way as to remove any disadvantages except the loss of interest on balances kept with the Federal Reserve Bank, and of this loss, much if not all, can be offset by making use of the discount, collection and other facilities of the Reserve Bank. . . .

I asked you to consider membership solely as a war measure and a national necessity. We are in a great war, and are only just beginning to visualize through the great battles now raging in France, the great sacrifices our allies are calling upon us to make. We are also in a period of great credit expansion. The Federal Reserve system is the only credit reservoir in the country. The commercial banks and trust companies, of themselves, have but little additional credit making power. They rely, whether members or not, upon the Federal Reserve system for the constantly growing credit they are obliged to extend to the Government and to their customers. They look to this great coöperative system to provide 100 per cent of all the additional credit which must be created, yet only about 65 per cent of the banking resources of the country have as yet been willing to contribute their propor-

⁴⁶ The Commercial and Financial Chronicle, May 12, 1917, p. 1834.

⁴⁷ Federal Reserve Bulletin, Nov. 1, 1917, p. 828.

tionate share to the common reservoir, upon which, whether contributors or not, they must rely, not only for their daily needs but for their ultimate safety as well. At the most critical period in the world's history, America's financial system should have, not 65 per cent but 100 per cent of the financial resources of the country standing solidly behind it. It should gather to itself every ounce of financial strength in order to unhesitatingly give to our Government and our industries the financial support they require, however vast it may be. For the Federal Reserve system to be able to give to the Government only two-thirds of the support it may require, because the other third of the banks are reluctant to make some little sacrifice of current earnings, is a situation to which I am sure you would not wish to be contributory; yet it is exactly the situation in which we find ourselves today.

Will not you and your fellow directors be good enough to consider the matter, not solely as trustees for your stockholders, in which capacity you may shrink from incurring a slight diminution of earnings, but primarily as trustees of the banking resources accumulated by your community, and of one of the integral parts of the Government's war machinery? Were it possible to explain the matter to your stockholders and your community, could there be any doubt of the overwhelming sentiment which would be found to exist in favor of having your bank contribute its share to the agency created to stand back of the Government and of the whole industrial fabric of the country at this time of crisis?

Will not you and your directors allow your bank to step forward, as a million of our young men have already done, and volunteer for the country's service? And will you not also please read to your directors again President Wilson's letter of October 13, 1917? If any further evidence of the need for prompt consolidation of our banking resources were needed, the events of the past fortnight in France have furnished it.⁴⁸

Pierre Jay, Federal Reserve agent of the Federal Reserve Bank of New York said:

But assuming that there would often be some loss, what would the loss amount to? Under no circumstances would it be so large as to affect a conservative dividend policy. Under no circumstances would it more than slightly retard the growth of surplus. Can we stop to consider such a trifling loss when civilization is hanging in the balance and thousands of American and allied soldiers are cheerfully giving up their lives for the cause? Must not our one thought be, "What can we do, what service can we perform, to

⁴⁸ From the library of the Federal Reserve Bank of New York.

help win the war?" For if we do not win it, profits and losses, dividends and surplus, will be of very little consequence.⁴⁹

The patriotic appeal to state banks to join immediately following the declaration of war did not bear fruit. Not a single state bank became a member of the Federal Reserve Bank of New York until after amendments⁵⁰ to the Federal Reserve Act in June, 1917, which made membership more profitable to them. By these amendments, most of the objections to membership were removed, and some of the regulations which the Federal Reserve Board had promulgated were given the force of statutory law much to the satisfaction of the state institutions.⁵¹ State banks and trust companies could become members of the Federal Reserve system and "retain at the same time their full charter and statutory privileges."⁵² Further inducement to join was offered by a decision of the Attorney-General of the United States, September 10, 1917, that this retention by the state banks of their charter rights released them from the restrictions of section 8 of the Clayton Act as to interlocking directorates which had previously been applied to all member banks.⁵³

Changes in the New York State banking laws also were effected in May, 1917, which were calculated to facilitate membership in the system and to make such membership more profitable for the state institutions. Accordingly, it was prescribed that any part of the "reserves on hand," that is the cash in the vault, in excess of 4 per cent of the deposits in the case of the commercial banks and in excess of 3 per cent of the deposits in the case of the trust companies, could be deposited in the Federal Reserve Bank. Furthermore, banks and trust companies were permitted to include Federal Reserve notes in their legal reserves by withdrawing the prohibition against their inclusion.⁵⁴ New Jersey and Con-

⁴⁹ Trust Companies Magazine, April, 1918, p. 310.

⁵⁰ Public Act, No. 25, 65th Congress, June 21, 1917.

⁵¹ Annual Report of the Federal Reserve Board, 1917, p. 13; Guaranty Trust Company, pamphlet entitled "Reasons for Entering the Federal Reserve System," Oct. 4, 1917.

⁵² Annual Report of the Federal Reserve Board, 1917, p. 13.

⁵³ Ibid., p. 14.

⁵⁴ The Commercial and Financial Chronicle, May 19, 1917, p. 1975.

necticut also passed laws permitting Federal Reserve notes to be counted as part of the legal reserves of state institutions.⁵⁵

The first addition to the New York Reserve Bank's membership in 1917 was that of a country bank on August 1. This was followed by that of another country bank in September, and the Guaranty Trust Company of New York City in October. Following the lead of the Guaranty, the largest state institution in New York City, most of the others in the city joined and a number from elsewhere in the district.⁵⁶ Altogether the membership of state institutions increased by 44 in 1917 and 56 in 1918. In no other year in the history of the Reserve Bank have the admissions of state banks approached these in number.⁵⁷ Besides the amendments and the Attorney-General's decision of 1917 other considerations were factors in enlarging the membership during the war years.

There was the pressure of public opinion and the patriotic motive of helping the Government finance the war. The Federal Reserve agent of the New York Reserve Bank attached especial importance to the element of patriotism,⁵⁸ although not one state bank responded to the appeal to country until after the war amendments to the Reserve Act, enabling greater banking profits to be made by joining, were passed. The weight of the following factors in causing a group of state institutions to join the Federal Reserve system was probably determining: making profits growing out of the rediscounting of war paper and the deposit of government funds, the value of being able to advertize—"Member of the Federal Reserve System," the amendment to section 22 of the Federal Reserve Act relating to transactions between member banks and their officers or directors,⁵⁹ and

⁵⁵ The Commercial and Financial Chronicle, Aug. 25, 1917, p. 740. Though national banks could not count Federal Reserve notes as part of their legal reserve, they could keep in their vaults as much currency in Federal Reserve notes as they wished.

⁵⁶ Annual Report of the Federal Reserve Bank of New York, 1917, p. 28.

⁵⁷ See Table 6, p. 158.

⁵⁸ Annual Report of the Federal Reserve Bank of New York, 1917, p. 28.

⁵⁹ Annual Report of the Federal Reserve Board, 1918, p. 81.

the feeling of safety due to possible need of drawing upon the resources of the Federal Reserve on account of the increased demands for credit and uncertain conditions as a result of the war.

In 1918, the United States Council of State Banking Associations suggested to the Federal Reserve Board an amendment to the Federal Reserve Act enabling certain classes of savings banks to become members of the Federal Reserve system.⁶⁰ The savings banks were especially desirous of membership at that time in order to obtain a share of the business of handling war loans and obtaining government deposits growing out of them. The proposal to admit savings banks continued to be talked of in certain quarters. Finally, mutual savings banks, Morris Plan banks, and "other incorporated banking institutions engaged in similar business" were made eligible to membership under the liberalizing provisions of the Banking Act of 1933.

Membership since the War

In spite of the campaign of patriotism and legal changes making membership more profitable, there were approximately 200 eligible state banks and trust companies in the New York district at the end of 1918, which were non-members. Twice as many eligible state institutions were outside the system as were in it.⁶¹ Hence the question of state bank membership remained after the war. It has been the object of discussion ever since then and is still a problem.⁶² Early in 1919, the New York State laws were amended in such a way as to reduce the percentage of reserve which a state institution, becoming a member of the Federal Reserve system is required to carry, and to make it no longer necessary for such institutions to carry a required percentage of their deposits in cash in vault.⁶³ The effect of these changes upon membership in the New York Reserve Bank was inappreciable.

⁶⁰ Federal Reserve Bulletin, January, 1919, p. 50.

⁶¹ See Table 6, p. 158.

⁶² See chapter VI, p. 123, concerning efforts to reduce the Government's share.

⁶³ Federal Reserve Bank of New York, Circular No. 159, April 5, 1919.

In response to a congressional inquiry on membership in the Federal Reserve system in 1923 the New York Reserve Bank reported to the Federal Reserve Board on this question as follows: ⁶⁴

The reasons given by non-member banks in this district for not joining the Federal Reserve system may be summarized as follows, in the order of their importance:

1. Cost, because of the loss of interest on balances, inability to count cash in vault as reserve, and limited dividends.
2. Ability to secure benefits from correspondents without membership, and disinclination to sever these relationships.
3. State laws, prescribing reserve requirements at variance with the requirements prescribed by the Federal Reserve system.
4. Inconvenience of further examination and supervision.

While the consideration of cost was most often encountered by the Reserve Bank as an obstacle to joining, yet it found that in most cases very little or no additional expense was borne by state institutions which were members.⁶⁵ On this point the Bank reported: ⁶⁶

It does not appear, generally speaking, that membership has resulted in reduced profits to state banks whether through loss of interest on reserve balances formerly kept with city correspondents, or through loss of exchange on checks. Where earnings have been reduced in one direction they have been increased in others. The special services afforded by the system and the earmark of security which membership gives is usually regarded as ample compensation for any added expense incurred.

The situation is that membership may subject the state banks to certain losses which are more or less tangible whereas the benefits are in large part intangible or less easily calculated. But few country bankers have had a cost-accounting system which enabled them to accurately determine the cost of membership.⁶⁷ While the benefits of membership may enable the country state banker to operate more

⁶⁴ Inquiry on membership in the Federal Reserve system, Joint Hearings before the Committee on Banking and Currency of the United States Congress pursuant to Public Act No. 503, 1923, p. 51. (Hereafter cited as *Hearings on Membership, 1923.*)

⁶⁵ *Idem.*

⁶⁶ *Idem.*

⁶⁷ *Idem.*

effectively or profitably, they probably require more effort on his part and a higher degree of managerial ability. And while the benefits are quite easily obscured, such losses as interest on balances, inability to count cash in vault as reserve, and limited dividends are very patent to him.

It will be noted that among the reasons given for not joining the Federal Reserve Bank of New York, the loss of exchange charges does not appear. By 1923 the loss of exchange charges was not a deterrent to membership in that district because all non-member banks had made arrangements to pay their checks at par.⁶⁸ The Federal Reserve banks now absorb the costs which banks formerly claimed were the basis of their exchange charges. Hence such charges can no longer be defended and their loss by the banks cannot be legitimately advanced as a reason for not joining the system.

In its report to the Federal Reserve Board the Bank listed four methods of encouraging membership in the Federal Reserve system.⁶⁹ They were:

1. To compel membership by Federal law and undergo the test of the courts on the question of constitutionality.⁷⁰

⁶⁸ *Ibid.*, p. 52.

⁶⁹ *Ibid.*, pp. 53-54.

⁷⁰ When the banking reform law was under discussion, unified banking was proposed by W. P. G. Harding (later a governor of the Federal Reserve Board) in 1913, at which time he said: "In my opinion there should be, if possible, government supervision of state banks as well as national banks, and as all commercial banks do a collection and exchange business, it is therefore probable that they are doing an interstate business which would subject them to Federal supervision." (Willis, *The Federal Reserve System*, p. 443.) It was also urged by Senator J. T. Shafroth before the Senate Banking and Currency Committee. (Senate Hearings on the Federal Reserve Act, 1913, Vol. I, p. 960.) The Federal Reserve Board, in 1915, declared unified banking to be the aim of the Federal Reserve Act and urged its attainment. During the existence of the Federal Reserve system it has been proposed several times in Congress to force state banks into the Federal Reserve under the taxing power of the Federal Government. Unified banking has in recent years come to be widely discussed as a result of the investigation of the banking situation conducted by the Senate Banking and Currency Committee in 1931. (See *Hearings on Banking Systems*, 1931, p. 366.)

In March, 1932, the Federal Reserve Board was requested by the Senate Committee on Banking and Currency "to suggest a constitutional method of creating a unified banking system in the United States." In a lengthy analysis of this subject the Board's General Counsel concluded that "Congress has

2. To secure uniformity of reserve requirements for banks, both state and national.
3. To educate systematically all eligible non-member banks upon the value of membership, appealing both to their self-interest and to their public spirit.
4. To make membership more attractive financially.

The last named of these plans, making membership more attractive financially, would remove the chief obstacle to increasing the membership of state banks in the system, so far as the New York Reserve district is concerned.⁷¹

The desirability of bringing more state banks within the Federal Reserve organization rests upon several considerations. In the first place, the services and benefits of the Federal Reserve system would be brought directly to a greater number of communities, particularly those in the rural sections. This would mean that the ability of state banks to adjust themselves to changing economic conditions would tend to be increased. Enlarged membership would also increase the amount of bank credit under the authority of the Federal Reserve system and hence tend to increase the effectiveness of Federal Reserve credit control policies. Furthermore, the number of member banks in the system is not likely to remain constant but is likely to increase or decrease. A long continued decrease in membership would seriously impair, on the one hand, wide distribution of benefits of the Federal Reserve system, and, on the other hand, the inherent financial resources necessary to render such benefits.

A clearer understanding of the course of membership may be obtained by reference to the analysis of changes in mem-

the power under the Constitution to restrict the business of receiving deposits subject to withdrawal by check to national banks." (See Federal Reserve Bulletin for March, 1933, pp. 166-186, for the complete opinion.) The New York State Banking Board, presided over by the State Superintendent of Banking, adopted resolutions in March, 1933, deploring the competitive establishment of unit banks between Federal and state authorities, and memorialized Congress in favor of requiring, as soon as practicable, compulsory membership in the Federal Reserve system of all banks and trust companies in the state. (See Congressional Record [unbound edition], March 31, 1933, p. 1067.)

⁷¹ Hearings on Membership, 1923, p. 54. See chapter VI, p. 123, concerning plans to make membership more profitable for member banks.

bership as shown in Table 6, page 158. The number of member banks of the New York Reserve Bank at the end of each year showed an increase to and including 1928 when the peak was reached with a total of 938 banks. Beginning in 1929 the membership declined each year. The organization of new national banks was responsible for a greater number of additions to membership during the history of the Bank than the admission of state banks. Exclusive of 1915 when there was the group transfer of banks from another Reserve district, the war and post-war years, 1917-1920, accounted for more additions than occurred during any other period of equal length.

Losses to membership were most numerous during the depression years of 1931 and 1933. Mergers between member banks accounted for over half of the total losses. Suspension and insolvency were responsible for the next largest number of losses. Other losses included those occasioned by voluntary liquidation, absorption of a member bank by a non-member bank, the conversion of a national bank to a state bank, and the withdrawal of state member banks.

Group Banking and Membership

The comparatively recent development of group banking raises the question of its effect upon membership in the Federal Reserve system. The outstanding group banking system in the Second Federal Reserve district has been the Marine Midland Corporation, with headquarters in Buffalo, which comprised ⁷² twenty-two banks widely scattered over the State of New York. Although it has been the policy of the officers of this group not to cause the banks affiliated with it to withdraw from the Federal Reserve,⁷³ it appears that they look with more favor upon having their larger banks belong to the Federal Reserve, leaving the smaller ones to be "taken care of" by correspondent banks. The president of the Marine Midland Corporation in testifying

⁷² February, 1933.

⁷³ Hearings before the Committee on Banking and Currency, House of Representatives, 71st Congress, 2nd Session, under H. Res. 141, on Branch, Chain, and Group Banking, 1930, Vol. II, Part 9, pp. 1250-1251. (Hereafter cited as *Hearings on Branch, Chain, and Group Banking, 1930.*)

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TABLE 6

MEMBER BANKS IN SECOND FEDERAL RESERVE DISTRICT
CHANGES IN MEMBERSHIP *

	1914†	1915	1916	1917	1918	1919	1920	1921
MEMBERSHIP, FIRST OF YEAR	480	479	613	622	670	723	753	784
ADDITIONS								
Organization of national bank	0	6	9	10	2	19	29	21
Conversion of non-member to national	0	2	0	2	0	0	5	1
Admission of state bank and trust company	0	1	1	44	56	20	18	3
Resumption following suspension	0	1	0	0	0	0	0	1
Transferred from Third Federal Reserve District (national banks)	0	131	0	0	0	0	0	0
Transferred from First Federal Reserve District (national banks)	0	0	15	0	0	0	0	0
Other additions	0	0	0	0	0	0	0	0
Total additions	0	141	25	56	58	39	52	26
LOSSES								
Merger between member banks	0	3	2	1	5	3	14	12
Voluntary liquidations	0	1	3	0	0	3	1	0
Suspension and insolvency	0	0	0	0	0	0	0	1
Absorption, member by non-member	0	2	3	1	0	2	1	0
Conversion, national to non-member	0	0	8	6	0	1	2	0
Withdrawal, state member	0	0	0	0	0	0	3	2
Other losses	1	1	0	0	0	0	0	0
Total losses	1	7	16	8	5	9	21	15
NET CHANGE	-1	+134	+9	+48	+53	+30	+31	+11
MEMBERSHIP, END OF YEAR	479	613	622	670	723	753	784	795
National	479	612	620	624	622	631	650	662
State bank and trust company	0	1	2	46	101	122	134	133
Percentage of national banks	100.0	99.8	99.7	93.1	86.0	83.8	82.9	83.3
Percentage of state banks and trust companies	0.0	0.2	0.3	6.9	14.0	16.2	17.1	16.7

* Data for the years 1915-1927, 1929 compiled from Annual Reports of Federal Reserve Board. Data for the years 1928, 1930-1933 compiled from Annual Reports of the Federal Reserve Bank of New York.

† From date of opening, November 16, 1914.

before the House Banking and Currency Committee of Congress in 1930 said:⁷⁴

Mr. Dunbar (Member of the committee). Do you encourage your substation banks to become members of the Federal Reserve system?

Mr. Rand. We have not changed the banks that have gone into our group. If they are members of the Federal Reserve, we want them to remain members of the Federal Reserve. So far, we have not adopted a policy. I should say, however, our policy is to have our large banks, particularly, members of the Federal Reserve system.

Mr. Dunbar. Why should not the smaller banks be members?

⁷⁴ George F. Rand, *idem*.

TABLE 6—Continued

 MEMBER BANKS IN SECOND FEDERAL RESERVE DISTRICT
 CHANGES IN MEMBERSHIP—Continued

1922	1923	1924	1925	1926	1927	1928	1929	1930	1931	1932	1933	Total
795	803	835	855	880	913	937	938	931	914	841	827	
17	27	25	31	35	28	19	22	8	2	1	16 ^a	327
0	3	2	1	1	4	2	2	1	0	0	0	26
8	9	5	8	16	9	4	8	3	8	3	18	242
1	2	1	0	0	0	0	0	0	0	4	0	10
0	0	0	0	0	0	0	0	0	0	0	0	131
0	0	0	0	0	0	0	0	0	0	0	0	15
0	0	0	0	0	0	0	0	0	0	0	0	0
26	41	33	40	52	41	25	32	12	10	8	34	751
13	7	4	12	12	16	22	30	20	32	8	7	223
1	1	2	0	0	0	0	0	0	0	1	0	13
1	0	2	0	0	0	0	0	4	44	11	31	94
1	1	1	0	2	0	2	5	3	4	2	1	31
2	0	2	1	5	1	0	4	0	0	0	0	32
0	0	2	2	0	0	0	0	2	3	0	0	14
0	0	0	0	0	0	0	0	0	0	0	15 ^b	17
18	9	13	15	19	17	24	39	29	83	22	54	424
+8	+32	+20	+25	+33	+24	+1	-7	-17	-73	-14	-20	+327
803	835	855	880	913	937	938	931	914	841	827	807 ^c	
667	692	711	734	750	771	775	769	759	699	684	650	
136	143	144	146	163	166	163	162	155	142	143	157	
83.1	82.9	83.2	83.4	82.1	82.3	82.6	82.6	83.0	83.1	82.7	80.5	
16.9	17.1	16.8	16.6	17.9	17.7	17.4	17.4	17.0	16.9	17.3	19.5	

^a Organized to succeed 13 banks under conservators, 2 licensed banks, and 1 bank in receivership.

^b Includes 2 national banks whose successor banks were chartered in January, 1934.

^c Includes 50 unlicensed banks.

Mr. Rand. Well, we allow our banking boards a very large degree of local autonomy and where the board of directors of the local bank wish to become a member of the Federal Reserve system, we encourage it and sometimes they have not wished to become a member of the Federal Reserve system and we have not interfered with the local autonomy that they cherish.

Experience has been too limited and it is too early to be certain, however, as to the effect of the group banking movement upon the membership, resources, and control of the Federal Reserve system. But those who are interested in protecting and developing the nation's central banking system have felt that group banking constitutes a threat

to the financial integrity and public control of the system. Consequently they took such measures as were deemed necessary to safeguard the Federal Reserve and incorporated them in the Banking Act of 1933.⁷⁵ Where two or more banks are associated with the same holding company affiliate, this Act limits the participation in Federal Reserve nominations and elections to one of them.⁷⁶

⁷⁵ Public Act, No. 66, 73rd Congress, June 16, 1933.

⁷⁶ Banking Act of 1933, section 3(b).

CHAPTER VIII

CENTRALIZATION OF OPEN MARKET POLICY OF THE RESERVE SYSTEM

The New York Bank as Agent for Other Reserve Banks

The Federal Reserve Act authorized the Reserve banks to engage in open market operations under rules and regulations prescribed by the Federal Reserve Board.¹ In the very first stages of Federal Reserve open market development the New York Reserve Bank began to act as agent for the other Reserve banks in the purchase of open market paper in the principal money market of the country.² It was on the last day of 1914 that the New York Bank engaged in its first open market operation when it arranged to purchase a block of New York City warrants. Following this transaction other Reserve banks asked the New York Bank to act for them in the purchase of warrants.³ At the second meeting of the Governors Council held in Washington, January 20 to 23, 1915, the other Reserve banks appointed the New York Reserve Bank their agent in purchasing paper eligible under section 14 of the Federal Reserve Act.⁴ From the first year of its existence the New York Bank has held balances of the other Reserve banks and these have been used to fulfill its agency function in purchasing securities for the several Reserve banks. In addition the New York Bank has sold acceptances purchased for its own account to the other Reserve banks.⁵

One way by which the operation of the other Reserve banks has been governed by the policy of the New York Bank is shown, for example, in this: Bank acceptances from all over the country have tended to flow to the dealers

¹ Federal Reserve Act, section 14.

² Annual Report of the Federal Reserve Bank of New York, 1915, p. 20.

³ *Idem.*

⁴ *Idem.*

⁵ Annual Reports of the Federal Reserve Bank of New York.

in New York. In order to maintain a market for the acceptances and enable the dealers to continue in business the New York Bank has made heavy purchases of them. As a result its reserves ran low and in order to replenish them, it became necessary, with the approval of the Federal Reserve Board, to sell some of the acceptances purchased to the other Reserve banks.⁶ The other Reserve banks having surplus funds have generally coöperated with the New York Bank in this procedure and have not been compelled to do so by the Federal Reserve Board.

While purchases of various classes of paper were made by each Reserve bank independently of the others in their local markets, the several Reserve banks were more or less affected by what the New York Bank did in the principal money market. Each regional bank ordinarily bought the kind of paper it chose and at such times and in such amounts as suited its individual purposes. The paper purchased consisted of municipal warrants, acceptances, and government securities. There was no formal organization of Reserve bank representatives directing open market operations in the early years unless the Governors Council be considered as such along with its other work.

In so far as the generally independent open market practice was modified, it was largely in respect to the agency function which the Reserve bank governors had delegated to the New York Reserve Bank and the dominant power exercised by the New York Bank, operating in the principal money market, to which the other Reserve banks were subject. From 1915 to 1923, the part played by the Federal Reserve Board in these open market operations consisted almost entirely in formulating regulations concerning the eligibility of various kinds of credit instruments for purchase by the Reserve banks.

Origin of Central Control outside the Federal Reserve Board

Following the crisis of 1920 there was a general liquidation of credit which included a repayment of member bank

⁶ Annual Report of the Federal Reserve Board, 1919, p. 7; 1920, pp. 49, 51.

borrowings to the Reserve banks.⁷ As a result the volume of discounted paper in the portfolios of the Reserve banks was very low during the first part of 1922. With a view to increasing their earnings some of the Reserve banks purchased considerable amounts of government securities on their own initiative and for their own account.⁸ This buying of securities gave the Federal Reserve Board and the Treasury some concern. It was evident to them that the open market buying was not because the market needed more money but because the Reserve banks were inspired by the profit motive.⁹ The Reserve banks were bidding against each other and in the actual execution of the orders it was seen that their operations affected the price of government securities in such a way as to arouse the criticism of the Treasury. Moreover, the Reserve banks being the fiscal agents of the Treasury, it did not seem proper that they should be working at cross purposes with the Treasury or interfere with its plans. It was the governors of the Reserve banks who took the initiative in improving this situation.

In order to effect some coördination (1) between the open market operations of the several Reserve banks and (2) in their operations in the capacity of fiscal agents for the Treasury, there was appointed at the May, 1922 meeting of governors, a small committee. The committee was composed of the governors of the New York, Boston, Philadelphia, and Chicago Reserve banks. The governor of the New York Bank was chairman of the committee. At first the committee's work consisted merely in the execution of orders from the several Reserve banks for the purchase and sale of securities in an orderly way in the open market.¹⁰ It was, indeed, a central committee for the execution of open market orders. Its organization marked the first step toward the centralization of the open market credit policy of the Reserve banks.

It was not long, however, before the central committee

⁷ Annual Report of the Federal Reserve Board, 1923, p. 13.

⁸ Idem; Stabilization Hearings on H. R. 7895, 1926, p. 863.

⁹ Stabilization Hearings on H. R. 7895, 1926, p. 863.

¹⁰ Ibid., p. 310.

under the leadership of the New York Reserve Bank assumed increased authority. It is worthy of note that such enlargement of power was undertaken not upon the recommendation or authority of the Federal Reserve Board, but upon the authority of the Governors Conference. Mr. Strong, governor of the New York Reserve Bank, reported that at the meeting of the Governors Conference in October, 1922, the governors voted to give the new central open market committee power to make recommendations to the Reserve banks regarding purchases and sales of government securities.¹¹ Commencing in October, 1922, the central open market committee changed its functions in accordance with the decision of the governors. It no longer merely executed orders for the purchase and sale of securities for system account but recommended an open market policy to the separate Reserve banks.

Thus the second step in the centralization of open market operations was taken. This consisted in the assumption by this central open market committee of powers reserved to the Federal Reserve banks and the Federal Reserve Board. These powers involved the central control of open market policy and the determination of a Federal Reserve system credit policy by the Federal Reserve Board. This very important credit policy function was now to be undertaken by this governors' committee.

Considerations Leading to the Federal Reserve Board Resolutions of 1923

The importance of open market operations lies in their effects on rates of interest, the volume of member bank credit and general credit conditions. They have commonly been used to prepare the market for Reserve bank rediscount rate changes. The purchase of open market items places the member banks in the possession of funds, which, in case they are indebted to the Federal Reserve banks, they may use to liquidate such indebtedness. The sale of items in the open market reduces the member bank reserves and may

¹¹ Idem.

result in increased borrowings from the Reserve bank. Local money markets not having been established in each of the Federal Reserve bank cities, when the Reserve banks, in 1922, purchased independently the acceptances and government securities, they bought them for the most part in New York, the leading money market of the country.

Consequent upon the independent purchases it was observed that the payments in New York resulted in a reduction of the indebtedness of the New York banks to the Reserve Bank in New York. This was in accordance with experience abroad where it has become a well-recognized principle that when the central bank puts cash into the money market the indebtedness of the banks to the central bank tends to be correspondingly less. But this result did not follow in certain other Federal Reserve districts. Following such independent purchases it was noted that the borrowings of member banks outside the larger money centers were not correspondingly reduced.¹² A similar difference occurred in the case of open market sales. Following their sales of securities in the latter part of 1922 and the early part of 1923, the borrowings of the New York member banks at their Reserve Bank tended to increase. On the other hand at the same time it was noted that the member banks' indebtedness at their respective Reserve banks outside the money centers was not proportionately increased.¹³

From the time the first central open market committee of governors was organized (May, 1922) the Federal Reserve Board gave particular attention to the problem and investigated the whole open market situation. Not only did the ill effects and inconsistencies stated above receive its attention, but also the Board's relation to the question of control over the open market policy and operations of the Reserve banks. The result was that the Board took an important step to assert its authority over these operations in a set of resolutions approved on March 22, 1923. These are as follows:¹⁴

¹² Annual Report of the Federal Reserve Board, 1923, p. 15.

¹³ *Idem.*

¹⁴ Stabilization Hearings on H. R. 7895, 1926, pp. 864-865.

Whereas the Federal Reserve Board, under the powers given it in sections 13 and 14 of the Federal Reserve Act, has authority to limit and otherwise determine the securities and investments purchased by Federal Reserve banks; and

Whereas the Federal Reserve Board has never prescribed any limitation upon open-market purchases by Federal Reserve banks; and

Whereas the amount, time, character, and manner of such purchases may exercise an important influence upon the money market; and

Whereas an open-market investment policy for the 12 banks composing the Federal Reserve system is necessary in the interest of the maintenance of a good relationship between the discount and purchase operations of the Federal Reserve banks and the general money market; and

Whereas heavy investments in United States securities, particularly short-dated certificate issues, have occasioned embarrassment to the Treasury in ascertaining the true condition of the money and investment markets from time to time:

Therefore be it

Resolved, That the Federal Reserve Board, in exercise of its powers under the Federal Reserve Act, lay down and adopt the following principles with respect to open-market investment operations of the Federal Reserve banks, to wit:

(1) 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.

(2) That in making the selection of open-market purchases careful regard be always given to the bearing of purchases of United States Government securities, especially the short-dated issues, upon the market for such securities, and that open-market purchases be primarily commercial investments, except that Treasury certificates be dealt in, as at present, under so-called "repurchase" agreements: Be it

Further resolved, That on and after April 1, 1923, the present Committee of Governors on Centralized Execution of Purchases and Sales of Government Securities be discontinued and be superseded by a new committee known as the Open-Market Investment Committee for the Federal Reserve System, said committee to consist of five representatives from the Reserve banks and to be under the general supervision of the Federal Reserve Board; and that it be the duty of this committee to devise and recommend plans for the purchase, sale, and distribution of the open-market purchases of the Federal Reserve banks in accordance with the

above principles and such regulations as may from time to time be laid down by the Federal Reserve Board.

Thus, for the first time there was formulated a set of general principles to govern the open market operations. The Board then also first proclaimed its authority to control them as against the governors led by the New York Bank. In accordance with these resolutions the central open market committee of four governors was dissolved and a new committee was organized composed of five representatives from the Reserve banks. The Board designated the banks of New York, Boston, Philadelphia, Cleveland, and Chicago to select representatives and left it to the banks as to whether they would appoint governors or Federal Reserve agents.¹⁵ Governors were chosen in each case and the personnel of the new committee was the same as the one it superseded with the exception that the governor of the Cleveland Bank was added. The Board labeled the new committee the Open Market Investment Committee and empowered it to supervise open market operations for the system under the Board's direction.

As stated by Dr. A. C. Miller, "the theory underlying this whole thing was to put the open market operations substantially on the same basis as prescribed for discount operations by the Federal Reserve Act itself."¹⁶ That is true so far as the relation of the Federal Reserve Board to these two types of central bank operations is concerned. It marked the third step in the development of this phase of centralization.

A fourth step in the centralization of open market operations occurred in the fall of 1923. This was the establishment of a Federal Reserve system open market investment account.¹⁷ The system account was set up and operated by the New York Bank under the general supervision of the Open Market Investment Committee. Changes in holdings in this account were to be subject to the approval of the Reserve Board.

¹⁵ Ibid., p. 865.

¹⁶ Idem.

¹⁷ W. R. Burgess, *The Reserve Banks and the Money Market*, p. 218.

The Open Market Investment Committee

The understanding was that this new Open Market Investment Committee could make recommendations regarding credit policy to the Reserve banks and order purchases and sales in accordance therewith but that whatever it did was subject to the approval of the Federal Reserve Board even to fixing the acceptance rates.¹⁸ How did this new arrangement work out? The formal procedure worked in this way: The committee determined its policy. In cases where it was "legally necessary" such policy was submitted to the Federal Reserve Board for approval.¹⁹ It was then submitted to the individual Reserve banks who had the option of participation. The regional banks nearly always coöperated. There was no public announcement of the policy and the committee proceeded to carry it out.

The central committee's policy was that bankers' acceptances and short-term United States securities be purchased almost exclusively. There has been one large discount market in the country and that is in New York. Though the committee requested some acceptances be purchased in local discount markets, the bulk of them were bought in New York. The New York Reserve Bank fixed the buying rate on acceptances in the national New York discount market. The rate fixed would determine approximately the amount of acceptances the Bank would buy, since it determined the amount offered, and the Bank took those offered. As rapidly as they came in they were divided by the New York Bank. Some went to the credit of foreign banks. In this case the other Reserve banks participated in a contingent liability on account of a written blanket guarantee of payment at maturity.²⁰ The rest were divided among the Reserve banks in certain proportions, related to assets, which were fixed from time to time by the central committee with the approval of the respective regional banks.²¹

¹⁸ Stabilization Hearings on H. R. 7895, 1926, pp. 865-866.

¹⁹ *Ibid.*, p. 312.

²⁰ As to the percentage participation in this business on the part of the separate Reserve banks, see Hearings on Banking Systems, 1931, pp. 883-884.

²¹ Stabilization Hearings on H. R. 7895, 1926, p. 316; Hearings on Banking Systems, 1931, p. 92.

The decisions in the Federal Reserve system regarding the purchase of foreign bills of exchange have been made by the New York Reserve Bank. Such bills have been purchased by that Bank and allotted to the other Reserve banks on a pro rata basis.²²

There has been one large government securities market and that too is in New York. United States Government securities were purchased by the New York Reserve Bank for system account and apportioned in accordance with agreed percentages to the other Reserve banks.²³ Notice of the purchase was given to all Reserve banks and none was obliged to participate in the purchase until it had been submitted to and approved by that bank.²⁴ However, in case the committee decided that a certain amount should be purchased, and it was approved by the Federal Reserve Board, but one of the Reserve banks did not take its share, the New York Bank would commonly take it anyway.

In the case of distributing new issues of treasury securities, the individual Reserve banks did not deal with the Treasury. The governor of the New York Reserve Bank dealt with the Treasury directly, in consultation with the other governors on the committee, and then apportioned the securities by agreement among the Reserve banks.²⁵ The holdings of government securities by the several Reserve banks since the opening of the system account have largely reflected increases and decreases of totals in that account.

Centralization of Open Market Powers in the New York Bank

While we speak of the Open Market Investment Committee as doing something, in practice open market operations were handled for the most part by the New York Reserve Bank. Technically the committee did some things but they were usually motivated and actually accomplished by the head and driving force of the committee, the governor of the New York Reserve Bank. It was he who submitted

²² Hearings on Banking Systems, 1931, pp. 91, 92.

²³ Stabilization Hearings on H. R. 7895, 1926, p. 327.

²⁴ *Idem*.

²⁵ *Ibid.*, p. 278.

his ideas with which the committee's meetings were introduced.²⁶ The protection of the central committee was afforded the New York Reserve Bank by having the committee make formal recommendations to the Federal Reserve Board.²⁷ Since the market for acceptances and government securities centers in New York, the New York representative had closest contact with the problems involved and ordinarily would be expected to have the most definite convictions concerning them. As a result the views and attitude of the New York Bank carried the greatest weight with the committee.²⁸ So while technically responsibility for some part of the open market operations rested with the committee, since the head of the committee was the governor of the New York Bank, the New York Bank largely controlled the Open Market Investment Committee.

Dr. A. C. Miller of the Federal Reserve Board, in testifying before a congressional committee of inquiry, significantly answered a question concerning the method by which the policy of the five members of the committee was determined. He was asked: "A majority of those five determines?" Dr. Miller replied: "Well, it may sometimes be a majority of *one*. It may be that *one* is the majority."²⁹ The open market policy of the Federal Reserve system, in so far as we can speak of a system policy, which was carried through, for example, from 1923 to 1929, was the policy sponsored by the New York Reserve Bank.

Particular responsibility for "system" policy has been felt by the officers of the New York Bank upon those occasions when they have undertaken to analyze and defend it. From other Reserve banks also has come recognition of the New York Bank's power in handling the very important credit operations under the open market section of the Federal Reserve Act. In answering questions submitted by the Senate Banking and Currency Committee concerning various phases of open market operations, the other Reserve

²⁶ Hearings on Banking Systems, 1931, p. 801.

²⁷ Stabilization Hearings on H. R. 7895, 1926, p. 762.

²⁸ See Stabilization Hearings on H. R. 11806, 1928, p. 126.

²⁹ *Ibid.*, p. 191.

banks made repeated statements to the effect that the answers regarding them would be covered by the New York Bank.

Recognition of the leadership of the New York Bank in the Federal Reserve system as against the other Reserve banks and, indeed, the Federal Reserve Board, has also come from abroad. When English interests in 1927 desired a low rate policy at the New York Reserve Bank and it was forthcoming, they also desired that it be made fully effective by putting low rates in force at the other Reserve banks. When this issue was forced upon the Chicago Reserve Bank, through the Federal Reserve Board, the independence asserted by the Chicago Bank induced the scorn and alarm of London bankers.³⁰ But solace was found in the fact that after all the New York Reserve Bank's policy was what counted. The chairman of the board of a prominent banking corporation in London said:

Any way, the real power of a Reserve bank is its open market policy and fortunately this is in the hands of an open market committee. Since New York is your only money market of importance, New York dominates this committee and so dominates the whole Federal Reserve system. The Chicago crowd cannot help themselves. They can be made to fall into line with the policy of the New York Bank whether they want to or not.³¹

Furthermore, a more important and absolute control of open market credit policy of the Federal Reserve system was exercised by the New York Bank in the determination of the buying rate on acceptances. While the function of the central open market committee was mainly to regulate the time and amount of purchases and sales, the New York Reserve Bank fixed the acceptance rate which governed the bulk of the Reserve banks' purchases directly in regard to time as well as amount and indirectly affected the small balance of purchases of acceptances. It should be noted that the Open Market Investment Committee did not buy acceptances or government securities nor did it sell them to the Reserve

³⁰ Lionel D. Edie, "British Bankers Resent Mid-West Activities in Reserve System," *Chicago Journal of Commerce*, Nov. 6, 1928.

³¹ *Idem*.

banks. Open market purchases and sales of acceptances and government securities for "system account" have been made by the New York Reserve Bank.

The extent to which such acceptances and securities were held by the New York Bank and the amounts allotted to the other Reserve banks were brought out by the Senate Committee on Banking and Currency in its investigation of the Federal Reserve system.³² The amount of acceptances which were bought was not actually determined by the Open Market Investment Committee. It was determined by the Federal Reserve Bank of New York through its fixing of the buying rate on acceptances. And the amount of acceptances purchased by the New York Bank governed the amount that would ordinarily be taken by the other Reserve banks since each took a proportionate share of them. Thus it is seen how the New York Reserve Bank practically controlled the situation. The centralization of the open market powers of the Federal Reserve system was effected to a high degree in the New York Reserve Bank.

The Federal Reserve Board versus The Federal Reserve Bank of New York

As stated above, the resolutions passed by the Federal Reserve Board, March 22, 1923, constituted an effort of the Board to assert its authority over the open market policy of the system. The degree of authority granted by the Federal Reserve Act to the Board over open market powers of the Reserve banks was not as explicitly stated as it was with regard to its jurisdiction over rediscounting powers. And

³² See Hearings on Banking Systems, 1931, Part VII. On page 893 is shown the amounts of acceptances purchased by the New York Reserve Bank for the Federal Reserve system, the amount held by the New York Bank and the amount allotted to the other Reserve banks. On pages 886-892 and 894-898 are shown the amounts of acceptances acquired by the other Reserve banks in consequence of allotments by the Open Market Investment Committee. On pages 824-840 are shown the amounts of United States securities purchased through the Open Market Investment Committee, and independently, and held by the separate Reserve banks. The New York Reserve Bank set up a special investment account, allotments from which were directed by the Open Market Investment Committee, and purchases of United States securities by the Reserve banks were ordinarily made through the New York Reserve Bank.

members of the Board have believed that it was a reasonable question as to the extent of its open market authority.³³ The Board, however, held that it was entitled to such comparable authority and undertook to declare rather complete control over the open market powers of the Reserve banks in its edict of 1923, including the right to limit the purchases of the Reserve banks.

On the other hand the Reserve banks did not concede the right of the Board to regulate open market operations in the same way as lending operations. Some of the banks questioned the Board's authority to approve their open market purchases.³⁴ There were indications that if the Board declined to approve purchases "the board of directors of the Reserve Bank would go ahead on their own account and operate in the open market."³⁵ Regarding such an action Dr. Miller made this prophetic statement in 1926: "that would be fatal." His judgment was vindicated by the extensive open market purchases in 1927, which were inspired largely by the New York Reserve Bank.³⁶ These purchases led to the excessive securities speculation preceding the stock market crash of October, 1929, and, in his judgment, resulted in one of the most costly errors of banking policy in any country in 75 years.³⁷

Technically, the recommendations and conclusions of the Open Market Investment Committee were referred to the Federal Reserve Board, and approved, modified, or disapproved before being put into operation.³⁸ But during the investigation conducted by the Senate Banking and Currency Committee into the operation of the Federal Reserve system, in 1931, it developed that the open market operations were never "very adequately" under the control of the Reserve Board until quite recently.³⁹ As the Open

³³ See Stabilization Hearings on H. R. 7895, 1926, pp. 866-867, and Stabilization Hearings on H. R. 11806, 1928, p. 403.

³⁴ Stabilization Hearings on H. R. 7895, 1926, p. 866.

³⁵ *Idem*.

³⁶ Hearings on Banking Systems, 1931, p. 132. See chapter XIV, section on The International Conference of 1927.

³⁷ Hearings on Banking Systems, 1931, p. 134.

³⁸ Stabilization Hearings on H. R. 11806, 1928, p. 127.

³⁹ Hearings on Banking Systems, 1931, pp. 129, 158.

Market Investment Committee developed it operated, in effect, as a central bank.

The resources of the twelve regional banks were considered as a unit and under the nominal centralized control of the Committee, were "put into the pot" in the central money market of the country. When the open market policy of the New York Reserve Bank functioned in such a way as to neutralize any intended effect of rediscount rate changes over which the Reserve Board had more definite control, the power of the New York Bank over banking and credit in the country was brought into bold relief. The influence of the so-called outside Reserve banks was trifling.⁴⁰ The extensive "easy money" policy of 1927 in the open market was in reality a central bank operation. According to a member of the Federal Reserve Board who went through that period, "it could hardly have been more so if we had had but one bank."⁴¹

Formation of the Open Market Policy Conference

The disastrous consequences of the 1927 "easy money" program to aid Europe caused the outside Reserve banks to be more solicitous about the use of their resources. Largely due to their feeling, the old Open Market Investment Committee was dissolved by action of the Federal Reserve Board, March 25, 1930, and a new committee was constituted.⁴² The character and size of the committee were changed. This committee included representatives from each of the twelve Reserve banks and was officially known as the Open Market Policy Conference. Given the right to designate any representative of the Reserve banks they chose, the boards of directors appointed their governors in every case.

⁴⁰ *Ibid.*, p. 140.

⁴¹ *Idem.*

⁴² *Idem.* The effects of that "easy money" policy are pointed out in treating various topics. Particularly, see pp. 173, 269, 377, 385. Cf., in general, the following: Harold L. Reed, *Federal Reserve Policy, 1921-1930*, chapter IV; Charles O. Hardy, *Credit Policies of the Federal Reserve System*, Part I, chapters V-VIII; *The New York Money Market*, Vol. IV, Part I by B. H. Beckhart.

The following constitution of the Open Market Policy Conference shows the form of its organization and includes the general principles which governed its functions:⁴³

(1) The Open Market Investment Committee, as at present constituted, is hereby discontinued and a new committee, voluntary in character, to be known as the Open Market Policy Conference is set up in its place.

(2) The Open Market Policy Conference shall consist of a representative from each Federal Reserve bank, designated by the board of directors of the bank.

(3) The Conference shall meet with the Federal Reserve Board upon the call of the governor of the Federal Reserve Board or the chairman of the executive committee, after consultation with the governor of the Federal Reserve Board.

(4) The function of the Open Market Policy Conference shall be to consider, develop, and recommend policies and plans with regard to open market operations.

(5) The time, character, and volume of purchases and sales shall be governed with the view of accommodating commerce and business and with regard to their bearing upon the credit situation.

(6) The conclusions and/or recommendations of the Open Market Policy Conference, when approved by the Federal Reserve Board, shall be submitted to each Federal Reserve bank for determination as to whether it will participate in any purchases or sales recommended; any Federal Reserve bank dissenting from the proposed policy shall be expected to acquaint the Federal Reserve Board and the chairman of the executive committee with the reasons for its dissent.

(7) An executive committee of five shall be selected from and by the members of the conference for a term of one year, with full power to act in the execution of the policies adopted by the Open Market Policy Conference and approved by the Federal Reserve Board, and to hold meetings with the Board as frequently as may be desirable.

(8) Each Federal Reserve bank participating in the Open Market Policy Conference shall be considered as waiving none of its rights under the Federal Reserve Act; each Federal Reserve bank shall have the right at its option to retire as a member of the Open Market Policy Conference, but each bank while a member of the Conference shall respect its Conference obligations.

It will be seen from this statement that the purposes of the Federal Reserve Board in revamping the open market situation were several:

⁴³ Hearings on Banking Systems, 1931, p. 158.

1. To assure the several Reserve banks more autonomy over the control of their respective resources in the exercise of Federal Reserve open market policy.

2. To curtail the control exercised by the New York Reserve Bank.

3. To make the Federal Reserve Board the central controlling authority over open market powers.

4. For the effective use of the Board's power, to provide the administrative machinery for applying it.

5. A reaffirmation of the general aims to govern open market policy.

In order to execute the policies adopted by the Open Market Policy Conference, an executive committee was formed. This was composed of the governors of the five Reserve banks in the northeastern part of the United States—New York, Boston, Philadelphia, Cleveland, and Chicago. As far as the extent of its operations is concerned, the San Francisco Bank would properly have been represented on the committee, but it is too remote to make it practicable for anyone from there to function effectively on it. It was held that such an executive committee should be in close contact with the money market and would be obliged to hold meetings with the Federal Reserve Board as frequently as desirable.

Effect of Banking Act of 1933

Further and more definite control by the Federal Reserve Board over the open market operations of the system was provided in the Banking Act of 1933. Also official statutory recognition was given to the organization of an additional institution to carry out more effectively the open market provisions of the Federal Reserve Act. Under the new Banking Act there was created the Federal Open Market Committee composed of a representative from each Federal Reserve bank. The organization of the new Federal Open Market Committee and its relation to the Federal Reserve Board are set forth in the Act as follows: ⁴⁴

⁴⁴ Banking Act of 1933, section 8.

(a) There is hereby created a Federal Open Market Committee (hereinafter referred to as the "committee"), which shall consist of as many members as there are Federal Reserve districts. Each Federal Reserve bank by its board of directors shall annually select one member of said committee. The meetings of said committee shall be held at Washington, District of Columbia, at least four times each year, upon the call of the governor of the Federal Reserve Board or at the request of any three members of the committee, and, in the discretion of the Board, may be attended by the members of the Board.

(b) No Federal Reserve bank shall engage in open-market operations under section 14 of this Act except in accordance with regulations adopted by the Federal Reserve Board. The Board shall consider, adopt, and transmit to the committee and to the several Federal Reserve banks regulations relating to the open-market transactions of such banks and the relations of the Federal Reserve system with foreign central or other foreign banks.

(c) The time, character, and volume of all purchases and sales of paper described in section 14 of this Act as eligible for open-market operations shall be governed with a view to accommodating commerce and business and with regard to their bearing upon the general credit situation of the country.

(d) If any Federal Reserve bank shall decide not to participate in open-market operations recommended and approved as provided in paragraph (b) hereof, it shall file with the chairman of the committee within thirty days a notice of its decision, and transmit a copy thereof to the Federal Reserve Board.

In these provisions the framers of the Act, in effect, ratified the purposes of the Federal Reserve Board in adopting the open market procedure as of March, 1930. The present statutes, however, supplement that code of procedure, strengthen the hands of the Board in its control over open market operations, and tend to give the several Reserve banks more voice in formulating a system open market policy. It will be noted that the new law does not state the functions of the Federal Open Market Committee. It therefore devolved upon the Reserve Board to define the Committee's functions under the authority of paragraph (b) which empowers the Board to lay down the conditions under which open market operations may be carried on. In these new regulations the Committee's functions are prescribed by the Board.⁴⁵ It is the duty of the Com-

⁴⁵ Federal Reserve Board Regulations M, Series of 1933, Federal Reserve Bulletin, August, 1933, p. 502.

mittee "to consider the needs of commerce and business, the general credit situation of the country, and such other matters as may be called to its attention by the Federal Reserve Board or by any member of the committee and to formulate and submit to the Federal Reserve Board for its action recommendations in writing concerning the open market policy of the Federal Reserve system."

The final authority concerning open market policy is now unequivocally stated to reside in the Federal Reserve Board. The Open Market Committee is given the power to formulate general open market policy which it recommends to the Reserve Board. But no policy may be effective or be executed except when and to the extent approved beforehand by the Reserve Board. For the purpose of carrying out the Board's open market policies the Board prescribed an executive committee such as had evolved in practice in former years. The executive committee consists of five members and is elected annually by the Federal Open Market Committee from its own membership. The present Open Market Committee is composed of governors. Its executive committee consists of the representatives from the Reserve banks of New York, Boston, Philadelphia, Chicago, and Cleveland. As in the case of former open market committees the New York Bank's governor is the chairman of the system committee and its executive committee.

In carrying out the Reserve Board's policies, it is the duty of the executive committee to purchase and sell government securities and other obligations, and to allocate among the participating Reserve banks the total purchases held for their account, and to adjust such allocation from time to time to meet the changing needs of the respective Reserve banks. The executive committee is required to make such allocations with a view primarily of (a) enabling each Federal Reserve bank to maintain a suitable reserve position, and (b) equalizing as far as practicable the net earning position of the Federal Reserve banks.

Further centralization of open market operations in the hands of the Reserve Board is evidenced by a number of other requirements, the more important of which are:

(1) No Federal Reserve bank may purchase or sell government securities except in accordance with an open market policy approved by the Reserve Board and in effect at the time.

(2) In case a Reserve bank wishes to purchase or sell government securities for certain specific purposes, for its own account, it must first obtain the consent of the Reserve Board.

(3) The Reserve Board has the right in its own discretion to require the sale of any government securities purchased by an individual Reserve bank as in (2).

(4) Purchases and sales of obligations other than government securities must be in accordance with regulations of the Board appropriate thereto and must be reported daily to the Board.

(5) Rates of interest or discount on acceptances and bills of exchange must be in accordance with schedules approved by the Board.

(6) No obligations payable in foreign currency shall be purchased without the consent of the Federal Reserve Board.

(7) No Federal Reserve bank may engage in the purchase or sale of cable transfers for its own account without first obtaining the approval of the Board.⁴⁶

(8) No Federal Reserve bank shall engage in any open market transactions which are not of the customary character, which do not occur in the ordinary course of business, which are engaged in for the purpose of affecting general credit conditions or which may have a material effect upon general credit conditions, except with the approval of the Federal Reserve Board: Provided, however, that any Federal Reserve bank may purchase obligations for the purpose of affording relief in a situation involving specific banking institutions in its district.

Some autonomy of the several Reserve banks, however, is assured under the new law and regulations. A Federal Reserve bank is not legally compelled to participate in the

⁴⁶ An exception to this applies to the Federal Reserve Bank of Atlanta, which may purchase and sell cable transfers through its Havana agency.

system open market operations determined by the Board. It may file notice with the Board, within a reasonable time, of its decision not to participate. But in the absence of filing such notice a Reserve bank is deemed to have agreed to participate in any particular system operations and is expected to coöperate fully in carrying out the system policy. Independent buying or selling of government securities, apart from system open market policy, is granted to any Federal Reserve bank (1) in an emergency when it is necessary to afford relief involving specific banking institutions in its district; and (2) for other specific purposes for its own account, if consent is first obtained of the Federal Reserve Board. Finally, regarding open market operations in other than government securities, a degree of independent dealing is permitted each Reserve bank, when such dealing has no material effect upon general credit conditions.⁴⁷

Thus, on the whole, the new open market requirements preserve the regional principle when operations are of local concern or influence; but when they may affect general credit conditions, then the Federal Reserve Board has jurisdiction over them as the nation's central controlling authority. In the organization of the Federal Open Market Committee, all the Reserve banks are put upon an equal footing so far as legal representation is concerned. The power of the Reserve Board to control open market policy and transactions is definitely enlarged and strengthened. The new statutes, therefore, are calculated to increase the tendency of recent years to make Federal Reserve open market operations more a result of system policy rather than the policy of the Federal Reserve Bank of New York.

⁴⁷ Even these transactions, however, must be conducted under the regulations of the Board, and potentially, at any rate, the Board has a high degree of control over them.

CHAPTER IX

CENTRAL BANKING FUNCTIONS— RESERVES AND GOLD

Central banks are located in each of the principal countries of the world today, many of them having sprung into existence since the World War.¹ A study of them reveals that they do not function on exactly the same basis.² There are many differences in organization and methods of operation. Under these conditions there have been voiced various definitions of a central bank, evidencing the differences of opinion as to what really are its functions. There is, however, the traditional experience of a few European central banks led by the forerunner of them all, the Bank of England,³ and out of this experience has come a body of literature dealing with the operations of central banks and the principles of their administration.

In establishing the central banking system of the United States the framers of the Federal Reserve Act drew upon American and foreign experience. The central banking functions which we shall consider are the functions which were recognized in the Federal Reserve Act and are evidenced by its provisions. These functions may be classified under a few main heads as follows: holder of the reserves of member banks, custody and administration of the nation's gold reserve, regulation of foreign exchange, note issue, fiscal agent of the Government, and credit control.

¹ Regarding the development of central banks and banking throughout the world, 1918-1928, see Introduction by H. Parker Willis in *Foreign Banking Systems*, Willis and Beckhart, Editors.

² See Kisch and Elkin, *Central Banks*.

³ The Bank of England is not the first of existing central banks of issue founded. It is the second, the Bank of Sweden having been founded earlier. But the Bank of England is the forerunner of all central banks for the reason that it first adopted central banking functions, doing so in the second quarter of the 19th century.

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TABLE 7

MEMBER BANK RESERVE REQUIREMENTS UNDER ORIGINAL
FEDERAL RESERVE ACT

Banks	Total Legal Reserve Required: Percentage of Deposits		Distribution of Reserve (From Date of Establishment of Reserve Bank)		Balance
	Demand Deposits (Payable within 30 Days)	Time Deposits (Payable after 30 Days)	In Own Vault	With Its Reserve Bank	
Central Reserve city banks	18%	5%	6/18	7/18	Balance in own vault or in its Federal Reserve bank, at option of member bank
Reserve city banks	15%	5%	For first 36 months— 6/15, thereafter 5/15	For first 12 months— 3/15, to be increased by 1/15 each succeeding six months until total is 6/15	For first 36 months balance in own vault, or its Federal Reserve bank, or with national banks in reserve or central reserve cities. Thereafter balance to be kept in own vault, or with its Federal Reserve bank, or in both, at option of member bank
Country banks	12%	5%	For first 36 months— 5/12, thereafter 4/12	For first 12 months— 2/12, to be increased by 1/12 each succeeding six months until total is 5/12	For first 36 months, balance in own vault, or with its Federal Reserve bank, or with national banks in reserve or central reserve cities. Thereafter balance to be kept in own vault, or with its Federal Reserve bank, or in both, at option of member bank

Holder of the Reserves of Member Banks

Legal Reserve Requirements

A sine qua non of central banking is the concentration of reserves. The holding of the reserves of other banks is a condition precedent to other central banking functions. The Federal Reserve Act prescribed the transfer of part of the legal reserves of national banks and member state banks. This meant the shifting of reserves from their correspondent banks in the reserve and central reserve cities to the Federal Reserve banks. The requirements of the original Act are shown in Table 7.

Three significant points in connection with the original requirements are (1) the reduction of legal reserve percentages, (2) the gradual transfer of reserves, and (3) the optional placement of reserves. The original Reserve Act reduced considerably the legal reserves which had been required under the National Bank Act.⁴ This reduction was effected in two ways. The reserve percentages were lowered and deposits were classified into demand and time. The reserve percentage required for time deposits, those payable after thirty days, was made much less than for demand deposits. The reduction of reserve requirements was considered justified because of the greater efficiency of centralized as compared with scattered reserves, and also as a compensation to the banks for the non-payment of interest on their reserve balances with the Federal Reserve banks. The reserve percentage requirements at the close of a three-year period from the date of opening of the Reserve banks were to be as shown in Table 8.

It was decided to effect the transfer of reserves from the correspondent banks to the Federal Reserve banks gradually over a period of three years rather than all at once. The reason for this as given in the report of the House Committee on Banking and Currency in 1913 was: "A period of three years is granted during which the deposits of country banks may be kept with the present correspondent banks in order that the latter may not be unduly embarrassed by sudden

⁴ See chapter I, p. 4.

TABLE 8
MEMBER BANK RESERVE REQUIREMENTS UNDER ORIGINAL
FEDERAL RESERVE ACT
(After 3 year period)

Banks	Total Legal Reserve Required: Percentage of Deposits		Proportion in		Proportion in Own Vault or Federal Reserve Bank
	Demand	Time	Own Vault	Federal Reserve Bank	
Central Reserve city banks	18%	5%	6/18	7/18	5/18
Reserve city banks	15%	5%	5/15	6/15	4/15
Country banks	12%	5%	4/12	5/12	3/12

withdrawals while the new reserve banks will not be as suddenly compelled to provide for using a very large quantity of funds.”⁵

The original Act also provided that part of the legal reserves were to be kept in the bank's own vault and part could be kept at the option of the bank, after the preliminary three year period, in either its vault or in the Reserve bank of its district. The theory of the Reserve Act was that “in times when Reserve banks needed greater strength they would so alter their policy and adjust their rates as to attract this variable element of reserves to their own vaults, while at times when credit could properly be relaxed they would repel it and thus transfer to member banks the responsibility for enlargements of the volume of credit in the market, enabling them to proceed regardless of Reserve bank policy.”⁶ But owing to the intervention of the war the Act was amended so as to centralize member bank reserves 100 per cent in the Reserve banks, thus making possible a larger expansion of credit for war purposes. The war amendments to the Act having remained on the statute books, it was not possible to test the original theory of distribution of reserves.

⁵ Willis, *The Federal Reserve System*, p. 290. See also statement of Mr. Glass, *Congressional Record*, Sept. 10, 1913, p. 4648.

⁶ Willis, *op. cit.*, p. 1179.

As the possibility of American participation in the war increased, the Government was desirous of impounding the member banks' gold in the Reserve banks as a basis for war financing.⁷ An amendment to the Reserve Act, September 7, 1916, was directed to this end. It gave the Federal Reserve Board authority to permit member banks to carry in their Reserve banks any portion of their reserves which had been required to be held in their own vaults. Pursuant to this amendment the New York Reserve Bank in a communication to its member banks said:⁸

The permission thus given offers an opportunity to all member banks both to be relieved of the responsibility for unused funds held in individual vaults, and to strengthen their reserves with their Federal Reserve banks. It should also tend to encourage the concentrating of the reserves of each district with the Federal Reserve bank where they will serve as a proper basis for elasticity when demands for currency are made and will, of course, be immediately available in case of emergency.

A number of member banks in the New York district availed themselves of the option and deposited all their legal reserves in the Reserve Bank. After our entry into the war, a final step was taken under the amendment of June 21, 1917, in accordance with which all legal reserves must be kept in the respective Federal Reserve banks. At the same time the proportion of reserve to deposits was reduced thereby permitting greater expansion of the superstructure of credit. Since then the reserves required, all of which have consisted merely of balances at the Federal Reserve bank, have been as shown in Table 9.

The reserve percentage requirements which have been in effect from June 21, 1917, are subject to variation under the terms of the Agricultural Emergency Relief Act, approved May 12, 1933.⁹ This act provides that "the Federal Reserve Board, upon the affirmative vote of not less than five of its members and with the approval of the President,

⁷ In this connection it is interesting to recall the persistent opposition on the part of the New York bankers to the opening of the Federal Reserve banks until the return of "more normal" conditions. (See chapter IV, p. 74.)

⁸ The Federal Reserve Bank of New York, Circular No. 57, Nov. 20, 1916.

⁹ Public Act, No. 10, 73rd Congress.

TABLE 9
MEMBER BANK RESERVE REQUIREMENTS UNDER
AMENDMENT TO FEDERAL RESERVE ACT,
JUNE 21, 1917

Banks	Total Legal Reserve Required: Percentage of Deposits	
	Demand	Time
Central Reserve city banks	13%	3%
Reserve city banks	10%	3%
Country banks	7%	3%

may declare that an emergency exists by reason of credit expansion, and may by regulation during such emergency increase or decrease from time to time, in its discretion, the reserve balances required to be maintained against either demand or time deposits." This statute supplements the provision already in the Federal Reserve Act, which was intended to increase elasticity of currency under the Federal Reserve system.

As provided in the original Federal Reserve Act, the Federal Reserve Board may suspend the reserve percentages stipulated in the Act practically indefinitely subject to a certain graduated tax.¹⁰ Such suspension of reserve requirements, in effect a reduction of them, has never occurred. The new authority granted the Board with the approval of the President under the Act of May 12, 1933, permits the reserve percentage requirements to be reduced without the levying of a tax. Thus an additional means for relieving any stringency of credit or currency is delegated to the central banking Board. Moreover, the new provision permits an outright reduction of legal reserves and not merely a suspension. But the new law goes further. It increases the powers of the Federal Reserve Board in controlling credit in that the constituted authorities may increase the legal reserve percentages as well as decrease them.¹¹

¹⁰ Federal Reserve Act, section 11(c).

¹¹ See chapter XIII, p. 276, section on Enlargement of Federal Reserve Board's Authority.

Maintenance and Use of Reserve Balances

The legal reserves of the commercial banks were originally deposited in the Reserve banks almost entirely in the form of gold. Since then any form of money or bank credit acceptable to the Reserve banks has been receivable to apply on reserve accounts. Deposits are received by mail, telegraph, or through the window of the receiving teller; or deposits are created by borrowing.

These deposit credits in the Reserve banks, then, have served member banks as satisfying the legal reserve percentage requirements. In addition, such member bank reserve balances have constituted a central reserve against the deposits in non-member banks. The reason for this is that non-member banks have been required to maintain legal reserves in the form of deposit balances with member banks, and against such bankers' balances member banks were obliged to have a reserve the same as against other deposits. The member bank reserve balances in the Federal Reserve banks, therefore, have been the basis directly or indirectly of the nation's bank credit.

The member bank reserve balances have been active. They have been used as a basis for the nation-wide clearing and collection system. Federal Reserve banks have effected the transfer of reserves between commercial banks as settling agent for the clearing balances of the banks. In this capacity the Reserve banks have held deposit balances of non-member banks as well as of member banks.

From the beginning member banks have adopted the policy of carrying no excess reserves at the Federal Reserve bank, since no interest is paid on them. Member banks, therefore, have tended to keep their Reserve bank balances down to the legal minimum. As a result of dealings with its Reserve bank a member bank's reserve account fluctuated in amount. If the reserve went below the legal requirements, the member bank would have a penalty to pay. If the reserve went above, the member bank would lose the interest it could obtain by having that excess on deposit in its correspondent bank. The New York Reserve Bank, therefore, in its first year inaugurated the practice of coöperating

with its member banks in their effort to maintain their reserve accounts in accordance with the law and yet not lose interest on the excess. It was done in this way. The member banks arranged with their New York correspondents to transfer to the Reserve Bank, at the latter's request, sufficient funds as needed to offset amounts charged. On the other hand the Reserve Bank deposited any excess balances, built up through the operation of the collection system, with the member bank's New York correspondents.¹²

Member banks have also built up their reserve balances by (1) depositing cash or cash items, (2) the sale of acceptances and securities, (3) rediscounting eligible paper, and (4) borrowing on their own promissory notes collateralized by United States Government securities or eligible paper. Beginning with the war period in 1917, when such a method of borrowing was authorized, and ever since, member bank reserves have been built up chiefly on the basis of government securities.¹³

The New York Reserve Bank has aided its member banks in this by holding in custody government securities belonging to them. Member banks have kept themselves well supplied with "governments." They thus have been able to replenish any deficiency of reserves very easily and quickly by borrowing on them. Consequently they have felt no need to keep any surplus reserves. The intention of the Federal Reserve Act was that member bank reserves were to be built up by the rediscounting of commercial paper. But much the smaller proportion of them has been obtained in this way, particularly by the member banks in the New York Federal Reserve district.

With the reduction of reserve percentage requirements and the adoption of a class of time deposits carrying a much lower percentage as compared with demand deposits, the way was open for a tremendous expansion of the superstructure of credit. In addition to federal legislation during war time making for greater expansion of credit, such expansion

¹² Federal Reserve Bank of New York, letter to member banks, July 3, 1915.

¹³ See *The New York Money Market*, Vol. IV, p. 385.

was considerably augmented by a practice of commercial banks. This involved the shifting of demand deposit accounts to time deposit accounts which went on particularly in the decade of the '20s. By this process the banks were able greatly to increase their loans and investments since they were required to carry only 3 per cent reserve against time deposits in lieu of 13, 10, or 7 per cent against demand deposits.

Another practice of the banks, however, tended to reduce their Reserve bank balances. This was the sale of "federal funds." In this case one bank sells its surplus reserves to another bank in the same or another Federal Reserve district. Thus the bank buying the funds obviates borrowing from its own Reserve bank. In this way the reserve base for the superstructure of credit has been less than it otherwise would have been. The sale of federal funds has been most extensive in New York where the federal funds market has attained a high degree of development.

It was due to the desire to have no excess reserves that the market for federal funds originated. Banks with surplus reserves on a particular day have commonly loaned them for a day to other banks which found themselves short. While the market for federal funds has aided an individual bank to operate very close to its minimum reserve requirements, it has been the ability of member banks to replenish their legal reserves by borrowing from the Reserve Bank which has been fundamentally responsible for the general realization of the no-surplus-reserve policy.

Custody and Administration of the Nation's Gold Reserve

Acquisition of Gold

About two-thirds of the gold stock supporting the nation's monetary and banking structure was held by the Federal Reserve system, as shown in Table 10. The sources of the system's holdings of gold were (1) payment of subscriptions to capital stock of the Federal Reserve banks, (2) deposit of required reserves of member banks, (3) receipts resulting from regular banking operations, and (4) special efforts to acquire gold. The Federal Reserve Act required member

TABLE 10
MONETARY GOLD STOCK AND GOLD RESERVES
(End of year amounts in thousands of dollars)

Year	Total Monetary Gold Stock in United States *	Gold Reserve of Federal Reserve System †	Proportion of Total Monetary Gold Stock Held by Federal Reserve System	Gold Reserve of Federal Reserve Bank of New York‡	Proportion of Federal Reserve System Gold Reserve Held by Federal Reserve Bank of New York
1914	\$1,813,005	\$ 241,321	13.3%	\$ 91,350	37.9%
1915	2,312,061	542,413	23.5%	264,146	48.6%
1916	2,842,804	736,236	25.9%	287,145	38.9%
1917	3,155,009	1,674,405	53.1%	609,697	36.4%
1918	3,159,915	2,092,062	66.2%	624,959	29.9%
1919	2,944,127	2,062,845	70.1%	549,162	26.6%
1920	2,925,750	2,062,786	70.5%	473,412	23.0%
1921	3,660,301	2,874,995	78.6%	1,081,204	37.6%
1922	3,928,816	3,047,393	77.6%	956,784	31.4%
1923	4,243,869	3,080,032	72.6%	871,495	28.3%
1924	4,499,481	2,936,533	65.3%	959,602	32.7%
1925	4,399,425	2,701,315	61.4%	928,965	34.4%
1926	4,492,060	2,818,539	62.7%	961,552	34.1%
1927	4,379,268	2,733,187	62.4%	868,601	31.8%
1928	4,141,421	2,584,232	62.4%	716,698	27.7%
1929	4,283,923	2,857,051	66.7%	749,860	26.2%
1930	4,593,488	2,941,219	64.0%	1,007,122	34.2%
1931	4,460,099	2,988,892	67.0%	843,738	28.2%
1932	4,513,001	3,150,671	69.8%	1,016,087	32.2%
1933	4,322,599	3,568,976	82.6%	938,402	26.3%

* Gold coin and bullion (including foreign coin) held by United States Treasury and Federal Reserve banks (including gold held under earmark abroad) and United States gold in circulation. Sources: Annual Report of the Director of the Mint for the fiscal year ended June 30, 1933, p. 76; Circulation Statement of United States Money, Dec. 31, 1933.

† Prior to the June 21, 1917 amendment to the Federal Reserve Act, gold held to the credit of the Federal Reserve agents was not included in the gold reserves of the Federal Reserve banks. Since this amendment they have been included. The figures given as representing the gold reserves held by the Federal Reserve system and by the Federal Reserve Bank of New York for the years, 1914, 1915, and 1916, include the gold held by the Federal Reserve agents. Source: Compiled from the Annual Reports of the Federal Reserve Board.

‡ Source: Compiled from the Annual Reports of the Federal Reserve Board.

banks to pay for the capital stock of their respective Reserve banks in gold or gold certificates. Accordingly, the New York Bank acquired its first gold reserve, receiving one of three installments before it opened in 1914.¹⁴

The reserves of member banks were not required to be paid in gold or gold certificates. However, in the Second Federal Reserve District, as a result of solicitation by the Federal Reserve Board and the New York Bank, a large proportion were transferred to the Reserve Bank in the form of gold or gold certificates.¹⁵ In the course of its regular banking operations the New York Bank acquired gold (1) through the Gold Settlement Fund as a result of "favorable" balances accruing to it on account of inter-Federal Reserve district transactions and (2) from the member banks in its own district who deposited their gold holdings. Since the early period of the Reserve system member banks generally preferred not to keep gold in their own vaults and nearly all imports of gold consigned to New York banks were sent to the Reserve Bank. The gold kept in the vaults of the member banks could not be counted by them as reserve. By turning it over to the Reserve Bank they augmented their reserves or converted it into the wanted denominations of currency. Moreover, whenever the banks needed gold it was made available to them in any amount for transfer at home or abroad.

Special efforts to acquire gold were employed during the World War before the United States entered it and after the declaration of war. Prior to our entry into the war relatively large gold imports greatly increased the gold holdings of the commercial banks. It was felt by Federal Reserve authorities that this large stock of gold might be the basis of unwise credit inflation. Therefore, member banks were urged to turn it over to the Reserve banks where it would

¹⁴ Federal Reserve Bank of New York, Circulars Nos. 1, 1a, 15, and 21; Annual Report of the Federal Reserve Bank of New York, p. 9.

¹⁵ Annual Report of the Federal Reserve Bank of New York, 1915, p. 11; Federal Reserve Bank of New York, Circulars Nos. 57 and 74; The New York Times, Nov. 17, 1914; Federal Reserve Bank of New York, letter to banks in the Second Federal Reserve District, Aug. 10, 1917, published in the Federal Reserve Bulletin, September, 1917, p. 659.

be under centralized control. It was pointed out that later on, when possibly an outflow of gold would be required, such a movement could be effected with less disturbance to banking and business conditions.

During the period of American participation in the war, the efforts to impound gold in the Reserve banks were pushed vigorously. In a series of communications in 1917 to all member and non-member banks in the district, including trust companies and savings banks, the New York Reserve Bank urged them to send in gold and gold certificates. It stated that the purpose in thus impounding the gold was to strengthen the base upon which the credit power of the central banking system rested so that we might be placed in the strongest possible position for financing the war.

Several things were done to facilitate the impounding of gold in the Reserve banks. The war amendments to the Federal Reserve Act of June, 1917, included one which required all member bank legal reserves to consist of deposit credit on the books of the Federal Reserve banks. All the states with territory in the New York Federal Reserve district revised their banking laws so as to permit their state banks to use Federal Reserve notes to satisfy their legal reserve requirements. Then the New York Reserve Bank pointed out that Federal Reserve notes were available to all national banks for vault money, and to all state banks in the district for legal reserves and asked their coöperation in strengthening the banking system by exchanging their gold and gold certificates for Federal Reserve notes.

The Reserve Bank offered some inducements to stimulate coöperation on the part of the banks in its Federal Reserve district. It paid the transportation charges on the shipments of gold and gold certificates and, if they desired currency, the Bank paid the cost of shipping them Federal Reserve notes.¹⁶ Ordinarily the Bank received gold coin subject to the usual limit of tolerance, but from November, 1917, it received for a limited time gold coin at its face value.¹⁷ The Federal Reserve Board urged that gold be not

¹⁶ Annual Report of the Federal Reserve Bank of New York, 1917, p. 21.

¹⁷ Federal Reserve Bank of New York, letter to banks in the district,

used for Christmas gifts in 1917 and the New York Bank asked its member banks to avoid payments of gold for gift purposes, offering them new paper money instead to meet this demand of their customers. The gold impounding campaign resulted in greatly enlarged gold reserves in the Reserve Bank.

Administration of Gold Reserve

Under the Gold Standard Act of 1900, the Secretary of the Treasury was charged with the duty of maintaining the parity of all forms of money with gold. Since the establishment of the Federal Reserve system the responsibility for the maintenance of monetary convertibility into the standard of value devolved for the most part upon the Federal Reserve system. Especially was this the case since the accumulation of most of the gold in the Reserve banks during the war. The Federal Reserve banks were empowered to aid the Secretary of the Treasury in maintaining the gold standard and keeping all forms of money at parity with gold.

Of the total gold holdings of the Federal Reserve system about one-third was held by the New York Reserve Bank, leaving the remainder to be divided among the other eleven Reserve banks.¹⁸ Nearly all gold imports and exports of the United States were handled by the financial institutions in New York City. In so far as bank rates in the United States have affected international gold movements, it has been the discount rate of the New York Reserve Bank which has been instrumental in regulating gold movements between America and foreign countries. That Bank carried on the function of conserving and protecting the ultimate gold reserve of the nation's financial system in order that the gold stock should be adequate to meet any demands which might be made upon it.¹⁹ In so doing the New York Nov. 2, 1917; Annual Report of the Federal Reserve Bank of New York, 1917, p. 21.

¹⁸ See Table 10, p. 190.

¹⁹ Protection in this sense refers to the prevention of undue foreign drains of gold. It means that taking into consideration domestic and foreign claims, the New York Reserve Bank performed the function of "managing" gold for the American people, according to the judgment of those in control of that Reserve Bank.

Bank has been the major factor in managing the gold standard in this country.²⁰

The Federal Reserve Bank of New York, on occasion, endeavored to conserve and protect the nation's gold reserve by raising its discount rate, by open market operations,²¹ and by its currency policy. By the latter is meant the type of currency which it decides to pay out in response to a demand for currency. At times the Bank has sought to gather in the gold certificates in circulation and, at other times, to pay them out instead of Federal Reserve notes.²² In the latter case gold was impounded in Washington by the Treasury department and did not appear on the Federal Reserve statements. Thus (1) this impounded gold was further removed from accessibility as a basis for credit, (2) it was made to appear from a reading only of the Federal Reserve statements that the nation's gold stock was less, and (3) the Federal Reserve ratio was reduced.

The Federal Reserve banks helped materially in maintaining the parity of all forms of money with gold. To accomplish this they exchanged gold for all moneys, coined or issued. Moreover, the Reserve banks maintained the ready convertibility of bank credit into gold. Bank deposits formerly represented a potential demand for gold. The amount of gold, relative to total deposits, requested for use within the United States was ordinarily extremely small. However, when public confidence in the national and state banks waned, many people resorted to hoarding gold. Gold was demanded for bank deposits and supplied by the Reserve banks in substantial amounts. Until the government decrees of 1933, the parity of all forms of money with gold was maintained by our central banks. And in this work, such maintenance meant the convertibility of bank credit as well as money into gold.

Custody and Control of Gold Passes to the Treasury

As the confidence of the people in banks sank to a low ebb in 1932 and the early part of 1933, gold hoarding as-

²⁰ See also chapters XV and XVI.

²¹ See following section on Regulation of Foreign Exchange.

²² See Stabilization Hearings on H. R. 7895, 1926, pp. 906-907.

sumed serious proportions. Consequently the Government issued executive orders prohibiting the paying out, earmarking, and exporting of gold coin, bullion, and certificates. The first such prohibition was contained in the President's proclamation of March 6, 1933, declaring a bank holiday.²³ There followed from time to time other executive orders further tightening the ban and defining certain exceptions thereto.

Another step in the Government's control of the gold stock involved the turning over of the gold in circulation to the Government. Under the Emergency Banking Act of March 9, 1933,²⁴ the Secretary of the Treasury was empowered in his discretion, to require any and all individuals and organizations to deliver gold coin, gold bullion, and gold certificates owned by them to the Treasurer of the United States. The Secretary of the Treasury issued an order to this effect under date of December 28, 1933.²⁵ All persons subject to the jurisdiction of the United States were ordered to deliver such gold and were reimbursed in other kinds of money. Some exceptions were permitted under this Treasury order, including the gold owned by the Federal Reserve banks.

There was some discussion over the question whether the Government had the right to take over the gold owned by the Federal Reserve banks. President Roosevelt held that such power had already been vested in the Government under the Emergency Banking Act, but desired specific authority from Congress for this purpose. The final step by the Government, therefore, in securing ownership and control of the monetary gold stock, involved an enabling act, known as the Gold Reserve Act of 1934, which was passed by Congress and became the law on January 30, 1934.²⁶ The purposes of the Act as stated in its preamble are: "To protect the currency system of the United States, to provide for the better use of the monetary gold stock of the United States, and for other purposes."

With the enactment of the Gold Reserve Act all title and claims of the Federal Reserve Board, the Federal Reserve

²³ Federal Reserve Bulletin, March, 1933, p. 113.

²⁴ Public Act, No. 1, 73rd Congress, section 3.

²⁵ Federal Reserve Bulletin, January, 1934, p. 9.

²⁶ Public Act, No. 87, 73rd Congress.

banks, and the Federal Reserve agents in and to all gold coin and bullion were vested in the United States Government.²⁷ Payment therefor was made by crediting the accounts of the above authorities on the books of the Treasury. For balances in such accounts the Treasury has paid gold certificates.

The result is that gold, which formerly composed the bulk of the legal reserves of the American central banks has been transferred to the United States Government mints, assay offices, and the Treasury building in Washington, D. C. Deposited in those places, it is now stored in vaults and is under the custody and control of the Treasury department. In lieu of the gold coin and gold bullion, Federal Reserve banks now hold gold certificates as reserve for their note and deposit liabilities. Gold is still the basis of our money and credit system but the several forms of money and credit are no longer redeemable in gold. The custody and administration of the monetary gold stock of the United States, which the Federal Reserve system and primarily the Federal Reserve Bank of New York controlled for almost twenty years, have passed to the Treasury.

Regulation of Foreign Exchange

Closely related to the protection of gold reserves has been the regulation of foreign exchange rates. During two periods

²⁷ The Gold Reserve Act also included a prescription concerning the revaluation of the gold dollar. The Act of May 12, 1933 had granted authority to the President to revalue the dollar. The Gold Reserve Act provided that in case the President should reduce the weight of the gold dollar, this weight should not exceed 60 per cent of the old weight.

On January 31, 1934, the President issued a proclamation fixing the weight of the gold dollar at $15\frac{5}{21}$ grains nine-tenths fine, or at 59.06 per cent of the former weight of 25.8 grains. (See Federal Reserve Bulletin, February, 1934, pp. 61-70.) This devaluation of the gold dollar resulted in an increase in value, amounting to \$2,808,000,000, in the United States Government's stock of monetary gold. Reflecting primarily the devaluation of gold, the total stock of monetary gold of the Government, which was \$4,033,000,000 on January 31, 1934, became \$7,438,000,000 at the end of February, 1934.

Effective February 1, 1934, the United States Treasury undertook to purchase all gold offered at \$35 an ounce, compared with the old statutory price of \$20.67 an ounce, and to sell gold for export to foreign central banks whenever our exchange rates with gold-standard currencies reach the gold export point.

in its history the Federal Reserve Bank of New York was largely relieved of this responsibility by action of the United States Government in declaring an embargo on gold. The first period was during the World War and the second commenced in March, 1933.

At the time of the first gold embargo foreign exchange dealings were regulated by an agency of the Federal Reserve Board set up in New York City in the quarters of the New York Reserve Bank. At the time of the second embargo such transactions were regulated by an agency of the United States Treasury department, also located in the building of the New York Reserve Bank. During both of these periods the Federal Government agencies worked in close collaboration with the Reserve Bank. At all other times when gold movements were subject to the influence of central banking policy, the New York Reserve Bank largely did the regulating of them so far as any impulse emanating from this country is concerned.²⁸

Central banks have had a responsibility to a certain degree for foreign exchange rates because of the bearing of these rates on international gold movements and in order to lessen the risks involved in negotiating foreign trade contracts. Such banks, including the Federal Reserve Bank of New York, have been accustomed to hold foreign-currency bills for three purposes—to put surplus funds at interest, to stabilize interest rates in the home market, and as a secondary reserve, utilizing them abroad in lieu of gold when the exchange rates on a foreign market approached the gold exporting point. The influence of the New York Reserve Bank on foreign exchange rates has been expressed not only indirectly through discount rate changes and open market operations, but directly through dealings in the foreign exchange market. The Bank has endeavored to stabilize rates of exchange by buying and selling futures. When foreign exchange rates were normally weak, it has commonly purchased bills of exchange.

The Reserve Bank's problem has been not so much the

²⁸ See Stabilization Hearings on H. R. 7895, 1926, p. 502, and Hearings on Banking Systems, 1931, pp. 91, 899-903.

prevention of unfavorable rates of exchange as the supporting of weak foreign exchanges, which have generally ruled throughout its existence. Thus, for example, the New York Bank enlarged its purchases of bills stated in foreign currencies in 1927, 1929, and 1930, at a time when the foreign exchanges were weak and gold was likely to be sent to the United States. The Bank explained the reasons for its purchases in these years as follows: ²⁹

We sought to support exchange by our purchases and thereby not only prevent the withdrawal of further amounts of gold from Europe but also, by improving the position of the foreign exchanges, to enhance or stabilize Europe's power to buy our exports. In fact our efforts to support exchange were undertaken in the autumn during our heaviest export season when the foreign exchanges are normally under pressure, and these operations were liquidated when the seasonal strain had passed, our goods had been moved, and the position of the foreign exchanges had improved.

The decision in the Federal Reserve system as to whether or not bills stated in foreign currencies shall be purchased has been determined by the board of directors of the New York Reserve Bank.³⁰ None of the foreign-currency bills were acquired by the Open Market Investment Committee.³¹ The New York Bank has purchased foreign-currency bills from central banks of foreign countries. Such purchases of foreign exchange have been allotted on a pro rata basis by the New York Bank to the other Reserve banks. So far as the control of foreign exchange is concerned the Federal Reserve Bank of New York has been the central bank for the United States.

The great inflow of gold following the war and growing out of the war conditions resulted in unusually large hold-

²⁹ Hearings on Banking Systems, 1931, p. 901.

³⁰ *Ibid.*, p. 91.

³¹ *Idem.*

Under the Federal Reserve Act as amended by the Banking Act of 1933, the Federal Reserve Board issued regulations which take away from the New York Bank authority over purchases of bills stated in foreign currencies. The requirements now are that no obligations payable in foreign currency shall be purchased without the consent of the Federal Reserve Board. [Federal Reserve Board, Regulation M. Series of 1933, Section VII, (2).]

ings of gold which have continued. The problem of the Reserve Bank in protecting the nation from foreign drains of gold has been comparatively easy. The Bank has given more attention to the matter of redistributing the gold held here to foreign countries. But whether to retard the inflow of gold or to send it abroad, the efforts of the Bank to control international gold movements have met with most limited permanent success. Owing to the intervention of the war, nothing comparable to the degree of success in controlling gold movements which may have been expected has been possible.

CHAPTER X

CENTRAL BANKING FUNCTIONS— NOTE ISSUE AND FISCAL

Note Issue

Federal Reserve Bank Notes

A primary function of a central banking institution is to enable the banks of the country upon request to convert their assets into money. In order to maintain the liquidity of the banking system the Reserve banks were given the power of creating central bank credit in the form of bank notes. The Federal Reserve Act provided for the issuance of two kinds of central bank notes or paper money, Federal Reserve bank notes and Federal Reserve notes. They were to be issued under different terms and conditions but the authorization of the two types of currency had a common point of origin. It lay in the purpose of the Act to substitute an elastic note issue backed by commercial paper for the bond-secured national bank notes.

The intention was to retire the national bank notes. In order to facilitate their retirement, and to avoid any loss to national banks in the process and undue contraction of the nation's media of exchange, the Act authorized the Federal Reserve banks to issue what it called Federal Reserve bank notes.¹ These notes were to be issued and redeemed under the same terms and conditions as national bank notes except that the total which any Reserve bank could issue was not limited by the amount of its capital stock. The Federal Reserve Board has no authority over the issue of Federal Reserve bank notes.

National bank notes have not been retired as intended largely because of the opposition of national banks which desired to retain them for advertising purposes. Consequently, relative to other kinds of money, a small amount of

¹ Federal Reserve Act, section 18.

Federal Reserve bank notes has been issued. During two periods, however, there were important increases in the issue of these notes. But in both periods the unusual enlargement of the Federal Reserve bank note circulation was for other purposes. The first increase was due to a foreign emergency which involved one of our allies during the war.² A domestic emergency, the banking crisis of 1933, was responsible for another substantial issue of Federal Reserve bank notes.

During the Banking Holiday, March 6 to 14, the Bank Conservation Act was passed, March 9, 1933.³ Under this Act Federal Reserve bank notes became an "emergency currency." In addition to United States bonds, merely miscellaneous collateral acquired by a Federal Reserve bank could be pledged with the Treasurer of the United States as backing for them. They could be issued in unlimited amounts without any gold reserve. Each Reserve bank has control over their issue except that such issuance is subject to any regulations which the Secretary of the Treasury may prescribe.

The issue of Federal Reserve bank notes upon the security of miscellaneous collateral is limited to the period of the emergency recognized by the President by proclamation of March 6, 1933. After the President has declared by proclamation that this emergency has terminated, Federal Reserve bank notes must be backed, as formerly, by government bonds bearing the circulation privilege. A considerable volume of this type of Federal Reserve bank notes was issued during the national banking emergency throughout 1933.⁴ Consequently, Federal Reserve bank notes, which

² The Pittman Act, approved April 23, 1918, authorized the issuance of Federal Reserve bank notes to replace silver dollars which were melted to provide bullion for foreign use, especially to enable Great Britain to relieve an acute financial crisis in India. (See Annual Report of the Federal Reserve Board, 1918, pp. 77-79; W. P. G. Harding, *The Formative Period of the Federal Reserve System*, pp. 121-122.) At this time the amount of Federal Reserve bank notes in circulation rose from about 9 million dollars in April, 1918, to a maximum of over 209 millions in December, 1920. (See Annual Report of the Federal Reserve Board, 1927, Table 22.) From 1921 the amount of these notes in circulation gradually declined until they reached a low of less than 3 million dollars in February, 1933.

³ Public Act No. 1, 73rd Congress.

⁴ During this emergency the amount of Federal Reserve bank notes in cir-

were originally planned gradually to replace national bank notes and to be eliminated ultimately from our monetary system, have assumed new significance as emergency currency.

The Issue of Federal Reserve Notes

The real elasticity in our hand-to-hand medium of exchange was to be obtained, during the period of substitution of Federal Reserve bank notes for national bank notes and thereafter, by the currency designated Federal Reserve notes. Federal Reserve notes are a combination of government and bank notes. Legally, they are government notes since, under the Federal Reserve Act (1) the United States Government is ultimately liable for their redemption and (2) its agency, the Federal Reserve Board, technically issues the notes to the Reserve banks through its representatives, the Federal Reserve agents located at the Reserve banks, or it may refuse to issue any notes requisitioned. The ultimate authority having the power and responsibility of determining the amount of Federal Reserve note issue is the Reserve Board.

But Federal Reserve notes are also, legally, bank notes, inasmuch as the Federal Reserve Act makes them a first lien on all the assets of the Reserve bank issuing them. Since the amendment to the Reserve Act of June, 1917, each Reserve bank has included among its liabilities all its Federal Reserve notes in actual circulation. From the point of view of banking principles, Federal Reserve notes are bank notes issued by the Reserve banks. The Federal Reserve Act so treats them when it authorizes the Federal Board to charge interest on a Reserve bank's "outstanding Federal Reserve notes." But here again, this power possessed by the Federal Reserve Board is capable of being a substantial factor in the credit policy of the Federal Reserve system. From the point of view of banking principles, therefore, the central banking Board may also be an important

culuation increased from about 3 million dollars in February, 1933, to a maximum of 208 millions in December, 1933. Since then there has been a steady decline in the volume of these notes outstanding.

influence in determining the note issue policy of the Reserve banks.

Practically, however, the Federal Reserve banks have issued Federal Reserve notes. The position of the Federal Board in the matter has been passive.⁵ Its power of note issue has not been acted upon.⁶ The Reserve Act gives the Board the right "to grant in whole or in part, or to reject entirely the application of any Federal Reserve bank for Federal Reserve notes."⁷ But the Board has never refused the application of any Reserve bank for such notes. Each Reserve bank has determined the time and the amount of each issue of its own notes. Besides, the Reserve Board has never levied an interest charge on a Reserve bank's outstanding Federal Reserve notes. Furthermore, each Reserve bank has decided the terms of note issue. It has decided which type of collateral, among several kinds of eligible collateral, served as security back of the notes. Finally, each Reserve bank has also determined the relative amounts of this collateral on the one hand as compared with gold on the other with which the notes have been backed. Thus, in the exercise of the note issue function the Reserve banks almost solely have determined questions of money, credit, and banking policy. The note issue function has been in the hands of the Reserve banks and not the Federal Board. Federal Reserve notes, therefore, regardless of any divided statutory authority, have been in effect bank notes. Although the Reserve banks were not given a monopoly of note issue, they were granted a power of note issue superior to that enjoyed by the national banks.

Security and Elasticity of Federal Reserve Notes

Since the elastic element of our monetary system was to be supplied by the Federal Reserve notes, the intention of the Federal Reserve Act was that they were to be issued only against short-time self-liquidating paper. The original

⁵ See Annual Report of the Federal Reserve Board, 1921, pp. 96-98.

⁶ Of course there is excepted the sheer mechanical sense of acquiescing in the demands of the banks for notes and issuing them to the Federal Reserve banks.

⁷ Federal Reserve Act, section 16.

Act provided that the Reserve bank would receive Federal Reserve notes from the Federal Reserve agent upon turning over to him promissory notes and acceptances eligible for rediscount and amounting to 100 per cent of the value of the currency received. Against these Federal Reserve notes the Reserve bank was required to keep a reserve in gold of 40 per cent, thus making the total security behind them 140 per cent. The amount of Federal Reserve notes in circulation, therefore, was to fluctuate with the amount of commercial paper presented at the Reserve banks which would vary in accordance with the volume of business transactions.

Very early the practice of the New York Reserve Bank came to vary from the intention of the Federal Reserve Act. The Act provided that the Federal Reserve agent would issue to the Reserve bank currency only in exchange for an equivalent amount of commercial paper. In 1915 the Federal Reserve Board and the New York Bank desired to impound gold. After the Bank had handed commercial paper to the Federal Reserve agent and received Federal Reserve notes it began the practice of turning gold and gold certificates over to the Federal Reserve agent and receiving back a like amount of commercial paper held by the agent.⁸ This practice was continued in 1916 and 1917 and was known as "reversing the pump."⁹ It was defended by the Bank on the ground that it would strengthen its gold position and its ability to assist member banks and other Federal Reserve banks; also, that it would tend to prevent unwise expansion of credit which might occur if the commercial banks had control of the gold in their own vaults.¹⁰ Thus in reality the Reserve Bank was engaged in the practice of exchanging Federal Reserve notes for gold.

⁸ Annual Report of the Federal Reserve Bank of New York, 1915, pp. 18-19. The Bank did this under the authority of section 16 of the Federal Reserve Act, which provided that it could reduce its liability for outstanding Federal Reserve notes at any time "by depositing with the Federal Reserve agent, its Federal Reserve notes, gold, gold certificates, or lawful money of the United States."

⁹ Annual Report of the Federal Reserve Bank of New York, 1916, p. 16; 1917, pp. 18-19.

¹⁰ Annual Report of the Federal Reserve Bank of New York, 1915, p. 18.

The issue of Federal Reserve notes became a function of the gold policy of the Bank. This new currency became, in effect, gold certificates. By June, 1917, all outstanding Federal Reserve notes of the New York Bank were secured dollar for dollar by gold or gold certificates.¹¹ This was contrary to the intention of the framers of the Federal Reserve Act, which was that the gold deposited with the Federal Reserve agent was to furnish a basis for the redemption of Federal Reserve notes, and was not for the purpose of releasing commercial paper which could then be used as a basis for the issue of more notes.¹² However, in order to make possible a greater expansion of credit for war purposes, the practice was legalized by Congress under the Act of June 21, 1917. Gold held by the Federal Reserve agent as collateral for Federal Reserve notes was to be counted as part of the gold the Reserve bank was required to maintain as a reserve against its Federal Reserve notes in actual circulation. The effect of this amending act was to reduce the security back of Federal Reserve notes from 140 per cent to 100 per cent. Of this 100 per cent security at least 40 per cent was required to be a gold reserve but it could consist entirely of gold. In time of extensive gold holdings the New York Bank has enlarged the proportion of gold back of Federal Reserve notes. At other times when the Federal Reserve ratio has become low, the Bank has placed more eligible paper and less gold back of them.

Another amending act affecting the terms of note issue was that of September 7, 1916. In the first place, under this amendment, Federal Reserve notes could be issued upon the security of bills of exchange and bankers' acceptances rediscounted or purchased under the terms of the Reserve Act. During the war many of the acceptances held by the New York Bank were non-liquid. They were based upon supplies in storage, goods which had been destroyed or used in unproductive ways in war, and frequent renewals under a system of revolving credits.¹³ Since the war the Bank

¹¹ Annual Report of the Federal Reserve Bank of New York, 1917, p. 20.

¹² Willis and Steiner, Federal Reserve Banking Practice, p. 122.

¹³ See Willis, The Federal Reserve System, chapter XLIV.

has held acceptances which were non-liquid, representing goods not in the process of sale.¹⁴ It has, therefore, been possible for the Bank to issue Federal Reserve notes representing such non-liquid assets.

A second provision of the amendment of 1916 was that the Reserve banks could make advances to member banks on their own promissory notes secured by United States Government securities. The New York Bank established the policy early in 1915 of complete interchangeability between deposit credits and Federal Reserve notes. While the member banks' collateralised notes could not be held by the Federal Reserve agent as security for the Federal Reserve currency, member banks could take the proceeds of their borrowings in the form of Federal Reserve notes. This they have done. Since 1916, therefore, Federal Reserve notes have been issued indirectly upon the basis of United States Government bonds.

Authority to issue currency directly upon the basis of United States Government securities was given the Reserve banks as an emergency measure for a period of one year in the so-called Glass-Steagall Act of February 27, 1932.¹⁵ Following the passage of this act it was possible for the Reserve banks to purchase government securities in amounts sufficient to enable the member banks to meet not only the domestic demand for currency but the foreign demand for gold, and at the same time to reduce their indebtedness to the Reserve bank and to accumulate a considerable volume of excess reserves.¹⁶

The Federal Reserve Board stated that the Glass-Steagall Act had been a helpful factor in a disturbed situation and also of service to individual member banks in a number of instances.¹⁷ The Board went so far as to suggest the enactment of certain sections¹⁸ in permanent form, but in any

¹⁴ H. Parker Willis, "American Banking during 1930," *The Banker*, London, February, 1931, p. 155. See also *Hearings on Banking Systems, 1931*, pp. 212, 503, 852; Beckhart, *The New York Money Market*, Vol. III, pp. 325, 326, 330, 360-366.

¹⁵ Public Act, No. 44, 72nd Congress.

¹⁶ Federal Reserve Bulletin, February, 1933, p. 60.

¹⁷ *Ibid.*, p. 96.

¹⁸ In addition to the note-issue section, a section in the Glass-Steagall Act

event recommended extension of such authority for at least a year beyond March 3, 1933.¹⁹ Congress acted favorably upon the recommendation, extending certain provisions of the Glass-Steagall Act to March 3, 1934, including the one on the issuance of Federal Reserve notes.²⁰

As the time for the expiration of the extension period for the issuance of Federal Reserve notes directly against United States Government obligations drew near (March 3, 1934), the Senate passed a bill providing for the continued extension of this privilege.²¹ This bill passed the House but not without a delay and was not approved by the President until the afternoon of March 5, 1934. Consequently, for more than twenty-four hours, about \$400,000,000 of Federal Reserve notes in circulation among the people were unsecured.²² No action was taken because of this technical lapse, however, since the Federal Reserve Act prescribes no penalty in case the Federal Reserve agent and Reserve banks do not maintain the required security back of all Federal Reserve notes in circulation.

The act approved March 5, 1934²³ extended the emergency privilege of issuing Federal Reserve notes for one year, that is, until March 3, 1935 or until the expiration of such additional period not exceeding two years as the President may prescribe. The issue of Federal Reserve notes directly against United States Government indebtedness, therefore, is authorized at least until March 3, 1935 and, should the President so decide, until March 3, 1937. Under the Glass-Steagall Act and its extensions, the Reserve Bank issued Federal Reserve notes merely by segregating and pledging some of its government securities. Thus the Reserve

authorized the Federal Reserve banks, in exceptional and exigent circumstances, to make advances to member banks having a capital of not exceeding \$5,000,000 against paper that would otherwise not be eligible for discount, in case these banks lacked an adequate supply of eligible paper. These were the sections which were extended for a period of one year, that is to March 3, 1934.

¹⁹ Federal Reserve Bulletin, February, 1933, p. 97.

²⁰ Public Act, No. 326, 72nd Congress.

²¹ S. 2766, Congressional Record (unbound edition), Feb. 28, 1934, p. 3451.

²² It happened that March 3, 1934 was on a Saturday.

²³ Public Act, No. 115, 73rd Congress.

Bank has become an agency for doing directly what it has long done indirectly, viz., converting the public debt into paper money.

Federal Reserve notes have generally been issued on the basis of gold and United States Government securities and not upon self-liquidating credit instruments. Moreover, the note issue policy of the New York Bank cannot be ascertained merely by a study of the fluctuations in the issue of Federal Reserve notes. Gold certificates have been paid out in lieu of Federal Reserve notes to meet changes in the demand for currency. Although per se an inelastic currency, gold certificates have formed an integral part of the function of the Bank in providing an elastic currency.²⁴ This has been possible because of the unusually large stock of monetary gold in this country. So far as the function of note issue is concerned, the idea incorporated in the original Federal Reserve Act, of providing the United States with an asset currency varying with the needs of trade, has, in practice, largely disappeared.²⁵

Fiscal Agent of the Treasury

Transfer of Functions to Reserve Banks

In order to remedy the evils associated with the Independent Treasury system, it was provided in the Federal Reserve Act that the Reserve banks could be depositaries of the Government and serve as its fiscal agents. The authority was not mandatory but permissive, to be exercised at the discretion of the Secretary of the Treasury. The acquirement of fiscal agency functions on the part of the Reserve banks came about gradually. Prior to the

²⁴ See Stabilization Hearings on H. R. 7895, 1926, pp. 906-907.

²⁵ The following figures show the collateral held by the Federal Reserve agents against Federal Reserve notes issued (all banks) as of the dates stated:

Federal Reserve notes issued	Nov. 30, 1933	Aug. 31, 1934
	\$3,264,891,000	\$3,397,104,000
Gold	2,618,254,000	3,133,656,000*
Eligible paper	96,276,000	12,685,000
U. S. Gov't securities	597,600,000	294,000,000
Total collateral	3,312,130,000	3,440,341,000

* Gold certificates exclusively.

adoption of the Act the duties connected with the receipt, holding, and disbursement of funds and with floating government loans nominally devolved upon the Treasury department which utilized, in addition to its own facilities, those of national banks. The transfer of these functions to the Reserve banks was not begun until they had overcome some problems of organization.²⁶

National banks, for the most part, performed such functions for the Government until January 1, 1916. On this date the duties of fiscal agent commenced with the transfer to the Reserve banks of government funds on deposit in national banks in cities where was located a Federal Reserve bank.²⁷ The United States sub-treasuries continued to hold large sums of government deposits.²⁸ During 1916 and 1917, up to the entrance of the United States into the World War, the operations of the New York Reserve Bank were limited to accepting for deposit the receipts of government collectors of customs and internal revenues and paying checks and warrants drawn upon the Treasurer of the United States and coupons of United States bonds.²⁹

Immediately following the declaration of war the Reserve banks were charged with the important fiscal agency function of floating loans for the Government. As a result the services of the New York Reserve Bank were enlarged to include the following:³⁰

²⁶ Letter of Secretary McAdoo to the Federal Reserve Board, Nov. 23, 1915, designating the Federal Reserve banks fiscal agents of the Government commencing January 1, 1916, Federal Reserve Bulletin, December, 1915, p. 395.

²⁷ *Idem*; Annual Report of the Federal Reserve Bank of New York, 1916, p. 21; Annual Report of the Federal Reserve Board, 1915, p. 6.

²⁸ Federal Reserve Bulletin, February, 1917, p. 112.

²⁹ Annual Report of the Federal Reserve Bank of New York, 1916, p. 21; 1917, pp. 29-30. In 1916 the sub-treasuries and their relation to the Federal Reserve banks was the subject of investigation by the Secretary of the Treasury. The question was whether the sub-treasuries should be discontinued and their duties turned over to the Reserve banks. In his report to Congress, Secretary McAdoo advised against the discontinuance at that time of any or all the sub-treasuries and the transfer of their duties to the Reserve banks. A list of the duties and functions exercised by the sub-treasuries at that time is contained in the report. Federal Reserve Bulletin, February, 1917, pp. 110-112.

³⁰ Annual Report of the Federal Reserve Bank of New York, 1917, p. 30.

1. The sale and redemption of certificates of indebtedness.
2. The sale and delivery of Liberty bonds, the payment of coupons thereon, the exchange of bonds of small denomination for bonds of large denomination, and vice versa, and the conversion of bonds of one issue into bonds of another issue.
3. The administration of deposits of the United States Government in depositary banks in its district resulting from sales of certificates and bonds, and the examination, approval, and custody of the securities pledged to secure such deposits.
4. The sale of war-savings stamps and thrift stamps.

War Financing

The World War necessitated the raising of hitherto unprecedented sums. The decision of the government authorities to finance it for the most part by borrowing or credit inflation, rather than by current taxation, imposed a heavy burden upon the banking organization for funds. Successive issues of Liberty bonds were floated. The Secretary of the Treasury asked the Reserve banks to assume the duties incident to federal borrowing in their respective districts.³¹ As a result each Reserve bank became a central agency for the organization of bond-selling campaigns among the banks and the general public. The Reserve banks handled the routine matters of receiving payments for subscriptions, making deliveries, exchanges, and redemptions. They also sold numerous issues of treasury certificates of indebtedness in anticipation of bond issues and tax receipts. These short-time issues were utilized advantageously in enabling the Government to absorb accumulated savings

³¹ Concerning the war finance policies and operations of the Federal Reserve system, see the following for the years 1917, 1918, and 1919: Annual Reports of the Federal Reserve Board, the Federal Reserve banks, and the Secretary of the Treasury; and the Federal Reserve Bulletins. Consult also the following: Willis, *The Federal Reserve System*, chapters XLVII-LVII; Jacob Hollander, *War Borrowing*; B. H. Beckhart, *The Discount Policy of the Federal Reserve System*, chapters VI and VII; J. M. Chapman, *Fiscal Functions of the Federal Reserve Banks*, chapter V; Wm. A. Brown, Jr., *The New York Money Market*, Vol. IV, chapters XIV-XVI; Federal Reserve Bank of New York, *Current Operations of the Federal Reserve Bank of New York as Fiscal Agent of the United States*, May 20, 1919.

gradually without undue disturbance to the money market. The certificates also enabled purchasers to anticipate their payments on account of Liberty bond subscriptions and taxes.

The central banks made direct investments in government securities and loans to member banks, and indirectly to non-member banks, collateralized by the securities. Popular subscription campaigns were carried on among the people. Business organizations, large and small, and individuals in all sorts of circumstances were urged to subscribe for bonds. If they could not buy them outright they were urged to borrow and buy. To facilitate the sale of the bonds and certificates by the borrowing process, the Reserve banks loaned to member banks at interest rates substantially equal to or less than the rates carried by the government bond and certificate issues and also at preferential rates on such war finance paper as compared with commercial paper. The commercial banks thus advanced credit to purchasers of the security issues and in turn borrowed from the Reserve banks.

The result was an enormous manufacture of bank credit to serve the Government. Several amendments of the Federal Reserve Act, in 1917, made possible this expansion of purchasing power. The chief factors making for a greater expansibility of bank credit as a result of the amendments were: reduction in the reserve percentage requirements of member banks, member bank legal reserves consisted only of Federal Reserve bank balances, issuance of Federal Reserve notes in exchange for gold, and the increased advantages to state banks of membership in the system. The Government was dependent upon the facilities of the Federal Reserve banks and it was due to the existence of the central banking system that the Government was able to secure so easily the purchasing power to finance the war.

Its work as fiscal agent for the Government brought the New York Reserve Bank in close contact with every bank in the district, member and non-member alike.³² Although

³² Annual Report of the Federal Reserve Bank of New York, 1918, p. 24. See also chapter VII, section on Efforts to Increase Membership during the War.

the Bank could not discount directly for non-member banks, it purchased treasury certificates of indebtedness from them whenever necessary under an agreement on their part to repurchase the same within 15 days.³³ The Bank, also, under the authority of the Federal Reserve Board, rediscounted for member banks the paper of non-member banks when it was given to purchase Liberty bonds or certificates of indebtedness. This relieved pressure not only on member but non-member banks.³⁴

The successful distribution of the war bond issues among the American people is one of the outstanding achievements in the fiscal history of the United States. The head of the central organization which was charged with the sale of Liberty bonds in the Second Federal Reserve District was the governor of the New York Reserve Bank, Benjamin Strong. The major part which the New York Reserve Bank played in financing the war is shown in Tables 11 and 12. Over two-fifths of all the certificates of indebtedness sold in the United States during the war years was sold by the New York Bank in its Federal Reserve district. About 30 per cent of all the Liberty bonds issued were sold through the New York Reserve Bank.

TABLE 11

CERTIFICATES OF INDEBTEDNESS, 1917-1919

Year	Total Sales in the United States	Amount Sold through the Federal Reserve Bank of New York in the Second Federal Reserve District *	Proportion of Total Sales, Sold in Second (New York) Federal Reserve District
1917	\$ 3,880,570,000	\$ 2,422,075,500	62.4%
1918	10,742,094,000	4,091,260,000	38.1%
1919	11,246,820,500	4,506,155,500	40.1%
	\$25,869,484,500	\$11,019,491,000	42.6%

* Annual Report of the Federal Reserve Bank of New York, 1920, p. 55.

³³ Annual Report of the Federal Reserve Bank of New York, 1918, p. 24.

³⁴ Annual Report of the Federal Reserve Bank of New York, 1917, p. 27; 1918, p. 24.

TABLE 12
LIBERTY BONDS, 1917-1919

Title	Total Amount Issued	Amount Sold through the Federal Reserve Bank of New York in the Second Federal Reserve District *	Proportion of Total Sales, Sold in Second (New York) Federal Reserve District
First Liberty Loan	\$ 1,989,453,550	\$ 617,831,650	31.1%
Second Liberty Loan	3,807,865,000	1,164,366,950	30.6%
Third Liberty Loan	4,175,650,050	1,115,243,650	26.7%
Fourth Liberty Loan	6,964,581,100	2,044,901,750	29.4%
Victory Liberty Loan	4,495,373,000	1,317,646,600	29.3%
	\$21,432,922,700	\$6,259,990,600	29.2%

* Annual Report of the Federal Reserve Bank of New York, 1919, p. 44.

The government financing requirements necessitated not only billions of dollars but occasioned severe shifts of funds. The shifting of funds was bound to create a temporary demand for credit by various commercial banks. The Reserve banks, however, supplied the required amount of funds and the elasticity in the credit structure which was needed, by their rediscounting and open market operations. Thus the Reserve system aided the banks in meeting the war emergency by providing credit expansion, relieving the pressure on the money market, and equilibrating the credit flow which was disrupted on account of temporary shifts of funds. Although the Government placed a heavy responsibility upon the Reserve banks, it was one which they discharged admirably. It was the organization and credit facilities of the Federal Reserve system together with able leadership, which made possible the meeting of the Government's unprecedented financial requirements and its military victory with the Allies.³⁵

³⁵ By means of the Federal Reserve system the United States Government obtained the funds to finance not only its own military and naval operations

Services Rendered the Government

The growth in the fiscal agency operations of the Federal Reserve banks during the years 1917 to 1920 and the efficiency with which they were conducted made unnecessary the services of nine sub-treasuries.³⁶ Congress, therefore, approved an act, May 29, 1920, providing for their discontinuance on or before July 1, 1921.³⁷ The Secretary of the Treasury was authorized to transfer any or all of their duties to the Treasurer of the United States, the mints, assay offices, or Federal Reserve banks. In accordance therewith, the sub-treasuries were discontinued and the Federal Reserve banks took over the following duties previously exercised by them:³⁸

The receipt of gold coin and standard silver dollars for exchange.

The receipt of United States notes, Treasury notes, gold and silver certificates, and subsidiary and minor silver coins for redemption.

The exchange of various forms and issues of money.

The cancellation and shipment to Washington of currency unfit for circulation and the laundering of soiled currency which permits of this process.

The receipt from United States depository banks of their surplus deposits of internal revenue, customs, money-order, postal, and other government funds.

The receipt of deposits of postal savings funds, post-office funds, money-order funds, deposits on account of the 5 per cent fund for the redemption of national bank notes, deposits of interest on public deposits, and deposits of funds by government disbursing officers.

The payment of United States coupons.

The payment of checks and warrants drawn against the Treasurer of the United States.³⁹

but the billions of dollars which it loaned to allied European countries as well for such purposes.

³⁶ The United States sub-treasury system was authorized by the Act of August 6, 1846. In 1920 there were nine sub-treasuries located in the cities of Boston, New York, Philadelphia, Baltimore, Cincinnati, Chicago, St. Louis, New Orleans, and San Francisco.

³⁷ Annual Report of the Federal Reserve Board, 1920, p. 72.

³⁸ Ibid., pp. 72-73.

³⁹ Although the Federal Reserve banks are required like the sub-treasuries were, to pay all United States Government checks, in practice, whether the New York Reserve Bank pays them depends upon who presents them. While paying government checks arriving from commercial banks in the clearing

The receipt of funds for transfer to other points through Federal Reserve banks or branches located therein.

The Treasury department retained the function of custodian of reserve and trust funds consisting of gold coin and bullion and standard silver dollars securing gold and silver certificates respectively and held as reserve against United States notes. This function was to be discharged by the Treasurer of the United States, the mints, and assay offices, while to the Treasurer of the United States alone was reserved the duty of issuing gold order certificates on gold deposits.⁴⁰

In addition to the above operations of the sub-treasury, the Reserve banks have assumed the following services for the Government: sale and delivery of newly issued government obligations, redemption of securities called for payment or matured, denominational exchanges, interchanges of coupon and registered bonds, exchange of temporary for permanent bonds, conversions, transfers of ownership, purchase and sale of securities for Treasury account, maintenance and withdrawal of government deposit accounts with depository banks, custody of securities for the Treasury, holding on deposit the general funds of the Treasury, collection of checks and non-cash items for Treasury account, and transfer of government funds and securities.⁴¹

Relations with the Treasury

Since the Reserve banks are the fiscal agents of the Treasury, their policies have necessarily been affected by the program of the Treasury. Because the Secretary of the and collection process, the Bank's policy has been not to pay government checks presented by individuals at the paying teller's window, except in certain selected cases. The Reserve Bank's paying teller, in 1931, upon declining to cash a government check issued by the Veteran's Administration to a World War veteran, told him to take his government check to his grocery store for payment.

⁴⁰ Annual Report of the Federal Reserve Board, 1920, pp. 72-73.

⁴¹ As fiscal agent of the United States the Reserve banks deal not merely with member banks but with all commercial banks in their respective districts. For a detailed discussion of these services for the Government, see John M. Chapman, *The Fiscal Functions of the Federal Reserve Banks and Willis and Steiner, Federal Reserve Banking Practice*, chapters XXI and XXII.

Treasury and an appointee of his, the Comptroller of the Currency, are members of the Federal Reserve Board, it has been easier for the Treasury to get what it wanted than would otherwise have been the case. On the whole a high degree of coöperation has characterized the relations between the Reserve banks and the Treasury. There has been "a constant disposition not to work at cross-purposes, but to let the Treasury's program, whenever it is practicable, work in with the Federal Reserve's." ⁴²

From the commencement of the fiscal agency function on the part of the Reserve system, the bulk of the Treasury's business has been handled by the New York Bank. The war-time Secretary, William G. McAdoo, found that he could handle many matters more efficiently through the New York Bank and he tended to deal directly with it rather than with the Federal Reserve Board or the other Reserve banks.⁴³ As Professor Willis has stated: "Thus it often happened that important policies were initiated and put into effect without previous consultation with the Reserve Board, which received information only when the policies had been determined upon, and occasionally at a later date." ⁴⁴ During the long régime of Secretary Mellon the policy of dealing directly with the New York Bank continued and the Treasury depended upon that Bank in its dealings with the money market.⁴⁵ Although the Government maintains accounts with all of the twelve central Reserve banks, its principal account has been with the New York Bank. That Bank has purchased and distributed far greater amounts of United States certificates, notes, and bonds than any of the other Reserve banks.

In accordance with its policy of working directly with the New York Reserve Bank, the Treasury has furnished the Bank information regarding its forthcoming operations.⁴⁶ The information included data about government security

⁴² A. C. Miller, *Stabilization Hearings on H. R. 11806*, 1928, p. 264.

⁴³ See Willis, *The Federal Reserve System*, pp. 1210-1212.

⁴⁴ *Ibid.*, p. 1210.

⁴⁵ H. Parker Willis, "A Turning Point in American Banking," *The Banker*, London, December, 1928, p. 252.

⁴⁶ *Stabilization Hearings on H. R. 7895*, 1926, p. 1003.

issues and tax payments. With this advance information the New York Bank made plans to prevent disturbances in the money market and stabilize general credit conditions. The nature and extent of the coöperation between the New York Bank and the Treasury may be illustrated by what occurs on the quarterly tax dates. At each of these dates, the 15th of March, June, September, and December, the Treasury receives income tax payments, redeems maturing obligations, pays interest on a portion of its debt, and usually issues new certificates, notes, or bonds.

On account of the large number of income tax checks and their geographical distribution, it takes several days to effect their collection. The disbursements of the Treasury on the quarterly tax day are, therefore, usually in excess of its receipts and balances on deposit in banks, which balances the Treasury transfers to the Federal Reserve Bank. This situation results in (1) an overdraft of the Treasury at the Reserve Bank and (2) excess member bank reserve balances. To cover the overdraft the Treasury has followed the practice of obtaining funds temporarily from the Reserve Bank on a special certificate of indebtedness maturing in one day. Then, from day to day, as the income tax checks have been collected the Treasury replaced the certificates of indebtedness by successive certificates of smaller amounts until, after a few days, the whole sum was retired.⁴⁷

The excess member bank reserve balances created a problem in that they tended to "flood" the market. Consequently the Reserve Bank has intervened to reduce these member bank reserve balances. For this purpose several methods have been used by the Bank, viz., the sale of participations in the one-day treasury certificates of indebtedness to member banks, open market sales of government securities, and the non-replacing, or postponement of re-

⁴⁷ Cf. Annual Report of the Federal Reserve Board, 1929, p. 71.

By means of the treasury bill adopted in 1929 the Treasury has been in a position to prevent the size of the overdraft in the first place from being as large as otherwise. The reason for this is that the maturity of the bill may be made to fall not on the quarterly tax date but on one or more days following it, thus making the Treasury's tax receipts and disbursements coincide more closely.

placing, of maturing government securities or acceptances in its portfolio.⁴⁸ The difficulty of excess reserves in this situation has also been mitigated at times by action of the member banks in balancing an accumulated deficiency in the reserve account for a period ending on the tax day, and by the reduction of their indebtedness at the Reserve Bank.⁴⁹ Through the coöperation between the New York Reserve Bank and the Treasury the quarterly turnover of funds has been handled in such a way as to stabilize money market conditions and smooth out short-time interest rates.⁵⁰

As was the case during the war when the Reserve banks supported the Treasury by discounting paper collateralized with government obligations, since the war, in good times and bad, the Reserve banks have practically made a market for government securities. They have bought those not taken by others and thus have aided the Treasury in realizing its financial policies. The Government has been moti-

⁴⁸ W. R. Burgess, *The Reserve Banks and the Money Market*, p. 101:

⁴⁹ *Idem*.

⁵⁰ The total volume of operations for Treasury account, for example, on March 15, 1927, was nearly \$2,000,000,000. A detailed account of the quarterly tax day transactions at that time is given in the *Federal Reserve Bulletin*, April 1, 1927, pp. 249-250.

Transactions of this general character have taken place at most of the Federal Reserve banks on each tax date. The largest part of them, however, has occurred in New York, since it is there that most of the Treasury disbursements have been made to holders of United States Government securities. In addition to the financial institutions there having funds to invest, the New York money market has not only been the center for the investment of large amounts of out-of-town funds, but many short-term government securities originally purchased in other districts have tended to gravitate to the central money market.

In order to provide for current expenditures in quarterly periods following the tax dates, and to prevent a periodical contraction of credit in the money market, a system of special depository banks has been used. This involves the sale of treasury certificates of indebtedness to the depository banks which pay for them by giving the Government deposit credit, resulting in no strain on the money market. In recent years although the use of the treasury bill has supplemented and modified this practice, it has not superseded the special depository system. By the sale of treasury bills the Government can secure cash or Federal Reserve funds at any time during a quarter period. Consequently the Treasury does not need to accumulate on the tax dates sufficient bank deposits in the depositories to carry it through the quarter periods. (See *Annual Report of the Secretary of the Treasury*, 1920, pp. 171-173; John M. Chapman, *The Fiscal Functions of the Federal Reserve Banks*, chapter VIII.)

vated chiefly with the idea of borrowing at low interest rates in spite of all other considerations and the economic effects of such a policy. The result has been the maintenance of a large proportion of practically permanent debt in short-time form and the filling up of the portfolios of our central banks with government obligations.

In these fiscal agency operations of the Federal Reserve system the New York Reserve Bank has been the point of immediate contact with the Treasury and as such it has practically apportioned the purchases of government obligations among the other Reserve banks.⁵¹ During the war the Treasury centralized its banking business in the hands of the New York Reserve Bank.⁵² At that time the Federal Government made the New York Bank its representative in foreign transactions and that Bank also became the agent of the other Reserve banks in dealings with foreign parties. The Treasury policy begun during the war to centralize its financing in the New York Reserve Bank has continued and makes that Bank the special fiscal agent of the United States Government.

⁵¹ See chapter VIII.

⁵² See chapter XV, section on Banker for the Government in Foreign Transactions.

CHAPTER XI

CENTRAL BANKING FUNCTIONS AND EMERGENCIES

Emergencies

The Post-War Period of Inflation and Depression

Emergencies of the type which gave rise to the pre-Federal Reserve banking reform movement have arisen several times during the existence of the Reserve system. They occurred during the post-war period of inflation and depression and the recent depression beginning in October, 1929. Confronted with these emergencies the Reserve banks functioned as lenders of last resort. They brought into play their various powers and demonstrated their capacity for operating as a coördinated central banking system. In those trying periods the weightiest burdens rested on the officials of the New York Reserve Bank. In meeting them that Bank performed central banking functions of far greater diversity and complexity than any of the other Reserve banks.

The steady rise in commodity prices from 1915 culminated in the spring of 1920, when in May the index number stood at 247. At no time during the period of the rise and never before in peace times had prices and bank credit increased at such a rapid rate as during the twelve months preceding the decline.¹ In the ensuing months there occurred in America the most precipitous decline of the price level the country ever experienced, the low point being registered in January, 1922, with an index number of 138.

During this post-war period of inflation and deflation there were exceptional movements of funds in connection with the fiscal operations of the Treasury, seasonal requirements for the movement of crops and the purchase of raw

¹ Annual Report of the Federal Reserve Bank of New York, 1920, p. 7.

materials by industries. All of this resulted in very large demands upon the Federal Reserve and banks all over the country drew heavily on their New York correspondents. The New York City banks were called upon to meet not only the demands of their local customers but out-of-town business concerns as well. They loaned large sums to mercantile, manufacturing, and other customers in all parts of the country. The loans they made to their correspondent banks were even greater than they were before the regional central banks were established, being the largest on record.² The heavy demands for central bank credit bore, therefore, exceptionally on the New York Reserve Bank, which met them by rediscounting and open market purchases.

As expected by the framers of the Federal Reserve Act the demand for bank credit proceeded at an uneven rate in the several Federal Reserve districts. But during this post-war period of extreme speculation and price changes, the Federal Reserve system functioned as a unit in supplying credit to banks wherever needed. The Federal Reserve Board adopted the policy of equalizing as far as practicable the reserve position of the central banks. The Reserve banks not only served their respective districts but other districts as well. By the latter part of 1919 the demand for Federal Reserve credit in some districts was so great as to result in the Federal Reserve ratios of the Reserve banks falling below the legal minimum percentage in the absence of inter-district rediscounting. This situation continued during the depression years of 1920 and 1921.

The New York Reserve Bank, during the post-war period, appeared at times as a lender to the other Reserve banks and at times as a borrower. When the member banks in the New York district made such heavy demands for credit upon the Reserve Bank that they could not be met without a suspension of the reserve percentage requirements, resulting in the imposition of a penalty rate, the Bank rediscounted some of its paper with the other Reserve banks. When the Reserve banks in other districts experienced a similar situation, and the New York Reserve Bank's reserve position

² Ibid., p. 10.

permitted, the Bank rediscounted the paper of the other Reserve banks. The net amount of accommodation received from or extended to other Federal Reserve banks by the New York Bank for 1920 and 1921 is shown in Table 13. Actual and adjusted reserve percentages of each Reserve bank in connection with this inter-Federal Reserve bank accommodation is shown in Table 14.

TABLE 13

NET AMOUNT OF ACCOMMODATION RECEIVED FROM OR EXTENDED TO OTHER FEDERAL RESERVE BANKS BY THE FEDERAL RESERVE BANK OF NEW YORK, 1920-1921 *

Date 1920	Federal Reserve Bank of New York	Date 1921	Federal Reserve Bank of New York
Jan. 20	-75,649	Jan. 31	-51,827
Feb. 27	-55,308	Feb. 28	-22,654
March 26	-34,096	March 31	- 513
April 30	+92,683	April 30	+16,950
May 28	+82,054	May 31	+27,020
June 25	+56,567	June 30	+38,024
July 30	+ 6,474	July 30	+37,530
Aug. 27	-40,923	Aug. 31	+34,768
Sept. 24	-13,404	Sept. 30	+26,933
Oct. 29	-61,362	Oct. 31	+18,328
Nov. 26	-24,502	Nov. 30	+ 4,324
Dec. 30	- 6,917	Dec. 31	—

* End-of-month holdings in thousands of dollars. Plus sign indicates net accommodation extended; minus sign, net accommodation received. Annual Report of the Federal Reserve Board, 1921, p. 45.

While the Federal Reserve Board is empowered to require Federal Reserve banks to rediscount the discounted paper of other Federal Reserve banks, there was no compulsion exercised during this emergency. The Reserve banks coöperated with the Board so that all such transactions were effected voluntarily in response to the Board's wishes.³ The operations were effected quickly over the Federal Reserve private telegraphic lines and settled for daily through the Gold Settlement Fund in Washington. Thus central bank credit was shifted to and fro to whatever district needed and the Federal Reserve banks became in effect a single reservoir of credit under the direction of the Federal Reserve Board.

³ Annual Report of the Federal Reserve Board, 1919, p. 5; 1920, p. 48.

TABLE 14

ACTUAL AND ADJUSTED RESERVE RATIOS OF FEDERAL
RESERVE BANKS, 1919-1921 *

Federal Reserve Bank	1919		1920		1921	
	Actual per Cent	Adjusted per Cent	Actual per Cent	Adjusted per Cent	Actual per Cent	Adjusted per Cent
Boston	44.0	24.3	55.3	59.5	76.3	79.4
New York	40.0	36.2	40.0	39.5	83.6	84.0
Philadelphia	40.8	32.7	54.2	58.7	74.6	74.6
Cleveland	46.3	49.4	59.1	75.9	74.8	74.9
Richmond	40.9	43.5	45.4	40.3	43.7	41.1
Atlanta	52.8	55.2	40.7	24.8	40.5	35.9
Chicago	50.6	58.8	40.4	40.4	74.2	74.2
St. Louis	46.5	60.5	44.5	44.5	63.5	63.5
Minneapolis	39.4	39.4	39.8	27.7	47.3	47.3
Kansas City	43.1	41.3	41.4	25.2	48.6	48.6
Dallas	49.4	77.0	41.8	17.5	39.3	35.7
San Francisco	54.9	59.3	49.3	51.1	79.3	79.3
System	44.8	44.8	45.4	45.4	72.7	72.7

* Compiled from annual reports of the Federal Reserve Board. Percentages are based on end-of-year figures except in the case of 1921 where they are based on figures for the last day of November, the last month during which inter-Federal Reserve bank accommodation occurred.

The percentages are the ratio of total reserves to combined note and net deposit liabilities for 1919 and 1920; ratio of total reserves to combined note and total deposit liabilities for 1921.

"Actual" reserve ratios are those based on the reserves actually owned by the bank.

"Adjusted" reserve ratios are those based on its reserves *before* inter-bank borrowing or lending. The adjusted ratio is an index of the ability of a Reserve bank to loan to others or its need to borrow from them.

The Depression of 1929-1933

During the depression of the early thirties there were four critical emergencies which afford outstanding examples of the way the New York Reserve Bank has functioned as a central bank in times of stress. Each of these crises possessed differences which required different treatment. The first one occurred on the heels of the cataclysmic drop of security prices. Lenders all over the country—banks, corporations, firms, and individuals became alarmed. They called their brokers' loans and withdrew in the short space of two weeks over \$2,000,000,000 from the New York money market. A money panic was impending as a consequence of the secu-

city panic.⁴ The commercial banks in New York, in order to stop the panic, replaced the loans called by additional loans themselves, in such amounts as were necessary, to brokers and directly to customers.

The banks were able to do this because of the existence of the Reserve Bank which met this emergency promptly and placed at the disposal of member banks whatever sums were needed. The Bank extended credit in two ways, about half by lending and the other half by the purchase of government securities.⁵ Its action prevented threatened runs, a money panic, and bank failures in New York. In this case the demand on the part of the member banks was primarily for an increase in their reserve balances at the Federal Reserve Bank.

The second emergency was in December, 1930. By this time public opinion had become reconciled to the presence of a severe depression, although false prophets continually proclaimed its end and minimized its gravity. The solvency of industrial concerns and banks was questioned. A wave of bank failures spread over the country. Against this background a climax was afforded by the failure of two banks in the nation's financial center, in the shadow of the Federal Reserve Bank of New York, the largest one of which was a member bank. These banks had so overloaded themselves with real estate and other non-liquid assets that they could not meet the demands of their depositors for cash. Depositors in some other banks in the same general localities of the city became uneasy and withdrew unusually large amounts. These banks in turn called upon the Reserve Bank for currency to meet these excessive demands.

Moreover, the leading banks in the city were fearful lest they would be attacked with a run and obtained abnormal amounts of cash from the Reserve Bank. At this same time there was the usual maximum seasonal demand for currency for holiday purposes. As a result of this combination of

⁴ Dr. Adolph C. Miller of the Federal Reserve Board, in his testimony before the Senate Banking and Currency Committee in January, 1931, stated: "No banking system in the world has ever been subjected to the pressure and the test that the New York banks were in the last part of 1929."

⁵ Annual Report of the Federal Reserve Bank of New York, 1929, p. 8.

circumstances the New York Reserve Bank was subjected to an extraordinary emergency demand for currency. It met this emergency completely. In one week alone, ending December 13, the Bank supplied over \$170,000,000 in cash to its member banks.⁶ The Reserve Bank provided the requisite elasticity to the currency in this crisis in two ways, by loans and by purchases of government securities and bankers' acceptances.⁷ This crisis differed from the previous one, then, in that it involved a demand for cash instead of for Reserve bank deposits.

The third critical emergency was in the fall of 1931. A serious credit and gold crisis arose in several European countries in the summer of 1931. This was followed by the suspension of the gold standard in Britain in September. There was a scramble for gold which culminated in the so-called "run on the dollar." Several central banks which had funds on deposit in the United States or invested here began, the latter part of September, withdrawing their claims in gold. These withdrawals reached the proportions of a "drain." Never in the history of the United States and probably of any country had so much been lost in such a short time. Approximately \$725,000,000 of gold was withdrawn by foreign banks in a little over a month by earmarking and exporting.⁸ The domestic situation was characterized by failures and uncertainty in business and the number of bank failures was unparalleled in the history of the country.

The gravity of the situation expressed itself in the withdrawal of bank deposits throughout the country and the hoarding of currency. There was an acceleration of currency hoarding in October and at the same time some withdrawal of bank balances in New York by the interior banks. There were, therefore, the foreign drain of gold, currency hoarding, and the withdrawal of bankers' balances, all three of which converged at the same time on the large member banks in New York. The "Wall Street" banks in turn called upon

⁶ Annual Report of the Federal Reserve Bank of New York, 1930, p. 8.

⁷ Ibid., p. 9.

⁸ Annual Report of the Federal Reserve Bank of New York, 1931, p. 13.

the Federal Reserve Bank of New York to meet the crisis. This the Bank did successfully. As in the case of the two previous crises, the Bank furnished the necessary relief by lending and by purchasing securities. But, whereas, in the case of the first crisis, the member banks desired reserves, and in the second, money, in this emergency both reserves and money in large sums were required to meet their extraordinary demands.

The Bank Holiday

The last of these critical emergencies occurred in February and March of 1933. It proved to be, perhaps, the most severe banking crisis in American history. The new year, 1933, opened with more than three years of depression behind it. Business stagnation, unemployment, and low prices weakened the so-called liquid assets of the banks so that a considerable part of them became illiquid. Also, the banks, generally speaking, were waterlogged with non-liquid securities—real estate mortgages, government bonds, and stocks. These things added to several thousand bank failures had undermined confidence in the remaining banks. This lack of confidence expressed itself in the hoarding of currency and even of gold. The “money in circulation” was rising and the banks were being drained of their cash.

This was the situation when without warning early in the morning of February 14, the governor of Michigan proclaimed a banking holiday effective in his state for eight days. The immediately aggravating situation in Michigan was the frozen condition of some Detroit banks' assets. The Michigan moratorium gave an impetus to hoarding and resulted in a scramble for cash which became nation-wide. Unable to obtain sufficient cash in Michigan, business and financial interests there sought to secure it from other states. Banks in other states were, therefore, subjected to two additional pressures. There were the demands to supply cash to connections in Michigan and the increased withdrawals of bank deposits on the part of people stricken with new fear. When such large numbers of depositors withdrew, the banks were unable to meet these demands for cash. Hence the

bankers appealed to the state governments to come to their rescue. This the states did by declaring moratoria on banking operations or restrictions against withdrawals.

The Michigan banking holiday started a succession of state moratoria which did not cease until every state in the Union had invoked some kind of restriction on banking operations. Beginning with Indiana on February 23, there followed intervention by three states in February.⁹ By March 4, all the rest of the states had joined the movement.¹⁰ Uneasiness over the banking situation was not confined to our own country. During this crisis foreign central banks withdrew substantial amounts in gold mostly through earmarking operations at the Federal Reserve Bank of New York. Foreign demands continued in increasing amounts during February and early in March attained record proportions.¹¹

The vast banking debacle placed a heavy burden on the Federal Reserve banks but particularly the New York Reserve Bank. Funds began moving out of New York the latter part of January in consequence of sales of securities in the New York market by parties in other districts. In February, interior banks made heavy withdrawals of their New York correspondent bank balances. This movement was particularly induced by the Michigan bank holiday followed by similar restrictions in other states. The New York Reserve Bank served not only its own member banks but those in other districts as well. Thus, during the Michigan moratorium, when banking operations were suspended, and large amounts of cash were sought with which to carry on business and for payroll purposes, a considerable part of the funds sought were supplied by the New York Reserve Bank.¹²

The funds transferred by the Reserve Bank were for the account of commercial customers of its member banks and to meet the demands of the interior banks for the return of

⁹ Federal Reserve Bank of New York, *Monthly Review*, April 1, 1933, p. 1.

¹⁰ *Idem*; New York Herald Tribune, March 5, 1933.

¹¹ Federal Reserve Bank of New York, *Monthly Review*, March 1, 1933, p. 1; April 1, 1933, p. 2; The New York Times, March 4, 1933.

¹² Federal Reserve Bank of New York, *Monthly Review*, March 1, 1933, p. 1.

their New York balances. Most of the transfer of funds from the Reserve Bank was effected through the Federal Reserve wire transfer system, and the currency was supplied by the Detroit Branch of the Federal Reserve Bank of Chicago. But here was a situation where the New York Reserve Bank functioned not only to supply funds to the banks in other Federal Reserve districts but to send them cash from its own vaults as well. Part of the funds transferred consisted of actual currency shipped directly from the New York Reserve Bank to communities in Michigan.¹³

Member banks in all districts withdrew from the Reserve banks in a period of a little more than three weeks, February 8 to March 3, over \$1,700,000,000, the major part of which was withdrawn in the last week.¹⁴ New York City banks alone gave up bank balances of their correspondents amounting to nearly \$800,000,000 in order to help meet the increasing demands of the crisis. Simultaneously with the heavy drafts on the New York banks from the interior, foreign central banks withdrew large sums in gold. All of these demands converged upon the New York Reserve Bank. The Bank met the calls by supplying currency, largely Federal Reserve notes, for domestic use and gold to meet the foreign demand.

When member bank reserves were depleted, the Reserve Bank replenished them and continued to aid the banks by loans and by purchasing government securities and acceptances in the open market and directly from the banks. The extent of the nation-wide crisis is evidenced by the reduction in excess gold reserves of the Federal Reserve banks. From a high point of \$1,500,000,000 in January, they declined to a little over \$400,000,000.¹⁵ The decline was due to pressure from both ends. Gold was withdrawn from the Reserve banks for foreign account and for domestic hoarding. On the other hand, to meet the exceptional demand for currency, increasing quantities of Federal Reserve notes were issued, which necessitated more gold reserve.

¹³ *Idem*.

¹⁴ Federal Reserve Bank of New York, *Monthly Review*, April 1, 1933, p. 2.

¹⁵ *Idem*.

The pressure on the gold reserves of the system fell most heavily on the New York Reserve Bank. It was meeting not only the demands of banks in the Second Federal Reserve District, but in addition large demands from the districts of other Reserve banks. Its reserve ratio declined to near the legal minimum. In order to maintain its reserve position the Bank rediscounted a considerable amount of its paper with other Reserve banks and also sold government securities to them.¹⁶ The amount of paper which the New York Reserve Bank rediscounted with other Reserve banks during this crisis as shown by its weekly statements was, on March 8, \$210,000,000; on March 15, \$143,800,000.¹⁷ By March 22, this indebtedness to other Reserve banks had been liquidated. The extent to which the Bank drew upon other Reserve banks during this crisis by shifting government securities is indicated by the following reduction in its holdings.

(In millions of dollars)		
February 21		725
March 1		620
8		515
15		555
22		625
29		700
April 5		725

By March 4, a Saturday, every state had placed extraordinary restrictions upon banking operations. The resources of the Federal Reserve system were rapidly being depleted, business was disrupted, and fears of an economic collapse were heard from responsible quarters. On this date, also, a new administration assumed charge in Washington. The incoming president, Franklin D. Roosevelt, immediately attacked the banking crisis and issued a proclamation before business hours on the morning of Monday, March 6, which brought it to a head. The President's order declared a na-

¹⁶ Ibid., p. 26.

¹⁷ According to information supplied directly to the writer by an assistant Federal Reserve agent of the New York Reserve Bank, these figures represent the rediscounts of the New York Reserve Bank with other Reserve banks in 1933.

tional bank holiday, suspending all banking transactions including those of Federal Reserve banks.¹⁸

The national bank holiday terminated the draining of gold and currency from the banking system pending analysis and legislation making possible the opening of banks at the end of the suspension period without the probability of closing due to runs. Such legislation was quickly drawn up and the Emergency Bank Act was enacted March 9, 1933. On March 13, the Federal Reserve banks opened for business, after being closed to normal transactions for one week. Member banks also began to reopen on March 13. They were allowed to resume business as rapidly as they obtained licenses to function under the new regulations of the Secretary of the Treasury.¹⁹

The Emergency Bank Act and the Treasury regulations sufficed to restore confidence to a degree which brought about a return flow of currency to the banks. The restrictions against paying out gold and currency for hoarding were continued. Of the gold which had been hoarded a large proportion was returned to the Federal Reserve banks following an order of the Federal Reserve Board calling for a list of "gold hoarders" and threats of publishing such a list.²⁰ The excess gold reserves of the Federal Reserve Bank of New York and the other Reserve banks mounted and this nation-wide banking collapse passed.

Granted the occurrence of emergencies, the Reserve system has been of considerable aid to the banks and the public. Indeed, the central banking system has been a tower of strength. The effectiveness of its service in coping with emergencies, whether of local, community concern or of wide and even national moment has been inestimable. Through the exercise of its central banking functions, except for the complete collapse as represented by the national bank holiday, the Federal Reserve system has, at any rate, proven its capacity as an emergency banking system.

¹⁸ Federal Reserve Bulletin, March, 1933, pp. 113-114.

¹⁹ Federal Reserve Bulletin, March, 1933.

²⁰ Ibid., pp. 130-131; Federal Reserve Bank of New York, Monthly Review, April 1, 1933, p. 29.

The intention of the Federal Reserve Act, however, was that the Federal Reserve system was to be not merely an emergency banking system, but was to do what it could to prevent emergencies from arising. In no small measure the emergencies during the existence of the Reserve system have arisen because of the lack of exercise and improper use of its central banking powers embodied in the function of credit control.

Credit Control

Meaning of the Term "Credit Control"

By credit control, as the term is used herein, it is not to be inferred that central banks can decide upon a goal of a certain price level, and by a deliberate policy bring this result to pass. It was not to be expected that the Federal Reserve system could, or has the power completely to stabilize general credit conditions and prices. The Reserve banks could not prevent oscillations in business activity and employment under the existing economic system in which prices largely determine the direction of economic activity.

There are a number of factors affecting the price level with which the Federal Reserve banks have no contact and others over which they have no authority and no power to influence. The Reserve banks have been linked to the commercial banking structure, but about two-thirds of the number of commercial banks holding one-third of the banking resources have not been members of the Federal Reserve system. There are many financial institutions not dealing in commercial bank credit but whose operations vitally affect the amount of credit used in exchange. The United States Government has immense powers of influencing credit through its fiscal and monetary policies and its ability to shift its deposits between Federal Reserve banks and commercial banks.

Furthermore, the minimum gold reserve requirements of the Federal Reserve Act would make impossible the stabilization of the price level under all conditions. There are also changes in the factors affecting the production of goods

and even their distribution, not only national but international in scope. Such changes Federal Reserve authorities cannot determine in advance nor offset once they have occurred. Yet the influence of such factors on prices is fundamental.

The intention of the Federal Reserve Act was that the Reserve system should influence general credit and banking conditions, and that through sound policies and practices a direction should be given to financial and business operations resulting in a safer and more stable economic order. The Reserve banks were charged with the function of maintaining the liquidity of bank assets. As the author uses the term, credit control refers to the power of the Reserve system to adopt policies which tend to bring about these ends. There are several means by which the Reserve banks may influence the credit structure. Credit control deals with the means and powers possessed by these central banks by which they may regulate the quantity and quality of Federal Reserve credit outstanding and the uses to which member banks put this credit. By control is not meant complete dominion over credit and its effect on prices. Influence and regulation are the essence of credit control in modern central banking.

It is evident from a study of the Federal Reserve Act that its purpose was not only to establish a permanent organization which should render necessary aid in emergencies but that the central banks should carry out a policy calculated to prevent emergencies from arising. As the Federal Reserve Board said in its first annual report concerning the function of a Reserve bank: "Its duty plainly is not to await emergencies but by anticipation, to do what it can to prevent them."²¹

In the contemporary system of production of wealth, money and credit are fundamental factors. The quantity and quality of bank credit, and the time and manner of its injection into the economic system are of paramount influence and public concern. The fountain head of the national credit economy has been our central banking system. The Reserve banks have supplied the base for the superstructure

²¹ Annual Report of the Federal Reserve Board, 1914, p. 17.

of credit—the country's purchasing power. Through their policies they have determined in some measure the direction of economic activity by supplying the reserves of credit with which to carry it on, leaving the composite result to the kaleidoscopic play of vast economic and other forces.

The operations of the Reserve banks have exerted considerable influence upon general economic conditions. What has been the influence of central banking policy with regard to the various means of credit control? Has the management done what it could to prevent emergencies from arising? Have the policies tended (1) to prevent abuse of the central banking reserves of our economic system, and (2) to assure the liquidity of bank assets? Or have they, in short, stimulated the creation of unsound credit and thereby contributed to economic distress?

In determining the answers to these questions, we shall be primarily concerned with the New York Reserve Bank. This is for the reason that the New York Bank operates in the primary money market of America and has dealt with credit in the mass. Its problems have been national and international in scope and influence. We shall survey the operations respecting the instruments of credit control and note the tendency of each one in order to see what have been the effects of the policies adopted by the directing heads of the New York Reserve Bank.

Basis of Federal Reserve Control of Bank Credit

Federal Reserve banks are primarily bankers' banks. Not only was little dealing directly with the public authorized in the Federal Reserve Act, but the Reserve banks have engaged in still less. The Act authorized the Reserve banks to deal directly with the business public under the open market powers. The Reserve banks could buy two-name paper from business concerns and through such contact have a direct influence on the cost of credit. The central banks have, however, refrained from using this instrument of control, probably the most effective instrument which they had to use.²²

²² See chapter XII, pp. 247-248.

In so far as the Federal Reserve system has had power to influence the quantity and quality of bank credit used as a medium of exchange, nearly all of such power has been exercised indirectly through the member banks. The connection with member banks, the basis of Federal Reserve credit control as it has been practiced, lies in the fact that the Federal Reserve banks hold the required reserves of member banks in the form of deposit credit; and at times it is necessary for member banks to borrow from the Reserve banks in order to maintain legal reserves, to secure gold for exporting, and to obtain currency for their customers. The cost of such borrowing influences the price and volume of total bank credit in use. Also, the probability of not being able to borrow from the Reserve banks because of the use made of credit would tend to restrict credit for such use. The basis of Federal Reserve control of credit, therefore, centers in the member banks' reserve accounts.

Refusing to buy commercial paper, the New York Reserve Bank purchased bankers' acceptances and government securities. Moreover, in its open market acceptance operations the Bank confined its dealings to the largest finance companies. The responsibility for open market purchases has been primarily that of the Reserve Bank rather than the institutions with whom it dealt in the open market. The reasons for this are (1) the Reserve Bank has been the active factor in the purchase of government securities, (2) the Bank has fixed the acceptance rate which determined whether acceptance houses would sell the bills to the Reserve Bank, and (3) the Bank has had the power to refuse to purchase all acceptances which did not arise out of bona fide short-term commercial transactions.

The open market purchases of acceptances and government securities increased member bank legal reserves. Upon the basis of the enlarged legal reserves, member banks expanded the superstructure of credit. Thus, by limiting the amount of its open market purchases the New York Bank could have prevented to that extent an expansion of bank credit. Because of the lack of authority held by Reserve banks over the use member banks make of central bank

credit once obtained, the importance of directing a Reserve bank in such a way that member bank legal reserves are not increased by the purchase of non-liquid acceptances becomes evident. Consequently, through its open market powers a Reserve bank not only has possessed some control of the quantity, but of the quality of bank credit outstanding as well.

Regardless of the use made of the proceeds of member bank loans and investments, whether they go into manufacturing, merchandising, real estate, or dealing in securities, the resulting increase in member bank deposits concerns a Federal Reserve bank. This is for the reason that when the loans and investments of member banks increase their deposits increase. A larger amount of deposits necessitates more reserves at a Reserve bank. Since member banks commonly keep practically no excess reserves, they seek to borrow from a Reserve bank as the lender of last resort. If a Reserve bank declines to grant a loan to a member bank the latter must take up some of its loans or liquidate some of its investments.

Consequently the influence of the Reserve bank upon the extension of member bank credit and the use to which it is put lies in part in this: that member banks can calculate approximately their needs for more Federal Reserve credit as a result of increasing their loans and investments by a certain amount. As to whether they will increase them by a certain volume and in a certain field of business depends upon the credit policy of a Reserve bank at the time, such as is expressed, for example, through its rates, its open market operations and its attitude regarding the quality of the credit extended. A central bank restrictive policy either as regards total volume or the enlarging of a certain class of loans would tend to check member bank loans and investments.

In so far as member banks are confronted with a restrictive policy resulting in higher interest rates or being turned down at the central bank for any legitimate reason, they would tend not to make some loans in the first place. Ultimately, therefore, upon the decisions of the Federal Reserve officials

affecting the accumulation of member bank balances in the Federal Reserve banks rests the superstructure of credit; and through their credit policy the central banks can exercise considerable influence upon this superstructure. Because the use of credit in any field involves the central Reserve banks as stated, and may affect general economic conditions, the Reserve banks are obligated to prevent an expansion of credit resulting in inflation in any markets and to conserve their resources for the maintenance of a sound banking structure and the benefit of the whole community.

Control over the Use of Credit

The ability of a Federal Reserve bank to control the use made of member bank balances or bank credit based upon them has been relatively limited. This has been especially so because of the practice of member bank borrowing on promissory notes collateralized with government securities. However, a Reserve bank has some power over the use of bank credit. This power is considerable as between broad categories of credit, such as credit used for working capital versus that used for fixed capital purposes, and credit used for trade financing versus that used for carrying or trading in securities.

A Federal Reserve bank has no voice in the matter of passing upon particular applications for loans at the member banks and thus controlling the use of bank credit. But it does have some authority in this matter. A Reserve bank's authority lies in these respects:

1. Under its powers of examination and supervision it is the duty of a Reserve bank to see that member bank loans to customers are made according to law.

2. Under the open market powers a Reserve bank is authorized to analyze the quality of acceptances offered it. An insistence upon an underlying transaction of short-term commercial character in every case would tend to result in the creation of a larger proportion of liquid acceptances.

3. It is incumbent upon a Reserve bank to see to it that Federal Reserve credit is not used for purposes of speculation or investment. The intention of the Reserve Act was

that member banks may not utilize Federal Reserve credit as a basis for carrying or trading in securities.²³ In so far as member banks are indebted to a Reserve bank, while at the same time they have outstanding speculative or investment loans,²⁴ Federal Reserve credit is being used as a basis for such loans, because (1) the deposits resulting from such loans require Reserve bank balances to support them, and (2), generally speaking, without such borrowings from the central bank, such loans could not be carried, unless other legitimate demands for commercial bank credit were restricted. The Federal Reserve Board in its communications²⁵ of early February, 1929, sought the coöperation of the directors and officers of the Reserve banks to carry out the intention of the Reserve Act in this respect.

4. Whether the member banks are indebted to a Reserve bank or not, there is a moral obligation resting upon the directors and officers of the central banks to furnish leadership to the banking institutions of the country. Indeed this moral obligation is one not only implied from the nature of the Reserve system's duties, but it is specifically stated in the sub-title of the Federal Reserve Act that the Federal Reserve system is "to establish a more effective supervision of banking in the United States." As quasi-public institutions, the Reserve banks were obligated to do what they could to maintain the liquidity of the member banks for the safety of the depositors and hence the general community.

In order to confine bank credit to legitimate channels and carry on an intelligent credit policy, knowledge of the use member banks make of Federal Reserve credit is necessary. A prerequisite, therefore, is that member banks themselves know the purposes for which they (member banks) loan "money." As a result of a questionnaire sent by the Senate Banking and Currency Committee to banks and security affiliates it was found that various loaning officers had determined, even down to fractions of 1 per cent, the purposes

²³ Refers to securities other than United States Government issues. Federal Reserve Act, section 13.

²⁴ Loans used for the purpose of carrying or trading in securities other than United States Government securities.

²⁵ See chapter XIII, pp. 265-266.

for which their respective loans were made.²⁶ Hence member banks have known the use they make of Federal Reserve credit.

The New York Reserve Bank officers and directors in turn have known the use member banks have made of Federal Reserve credit. An official of the Bank stated before the House Committee on Banking and Currency that they had means of "knowing fully" the operations of the member banks.²⁷ Information as to how bank credit is used by member banks is obtained from reports of the examiners and from the staff of the member bank relations department.²⁸ From each of the New York City banks the Reserve Bank has received a daily report containing a statement of its deposits and brokers' loans. It also has received weekly reports of condition of about 800 reporting member banks in the principal cities throughout the United States which indicate the loans secured by stocks and bonds.

The New York Reserve Bank has not only been in "constant contact" with officers of the borrowing banks but in the case of such banks its practice has been to gather detailed information about them.²⁹ In the event of an application for a loan the credit department of the Bank has carried on the practice of gathering pertinent information regarding the condition of the borrowing bank which was submitted to the officers and executive committee. In the case of the New York City banks such information included the amount of its loans on the stock exchange and whether they were increasing or decreasing. The governor of the Bank testified before the Joint Commission on Agricultural Inquiry that the Federal Reserve officials could tell "pretty generally" whether or not Federal Reserve funds were being applied for the purpose of loaning on the stock exchange.³⁰

²⁶ Hearings on Banking Systems, 1931, pp. 266-267, 1010-1013.

²⁷ W. Randolph Burgess, Stabilization Hearings on H. R. 7895, 1926, p. 967.

²⁸ Stabilization Hearings on H. R. 7895, 1926, p. 969.

²⁹ Benjamin Strong, governor of the Federal Reserve Bank of New York, Hearings in the Agricultural Inquiry, 1921, Vol. II, pp. 709-710. See also Hearings on Banking Systems, 1931, pp. 722-723.

³⁰ Hearings in the Agricultural Inquiry, 1921, p. 710.

For the purpose of exercising the function of credit control, various means have been at the disposal of Federal Reserve officials. These means are discount and acceptance rates, open market operations, practice regarding rediscounts and advances, practice regarding acceptability, warnings, persuasion, refusal to rediscount or advance loans on "eligible" paper, and rationing of credit.

CHAPTER XII

CREDIT CONTROL—RATES, OPEN MARKET AND LOAN OPERATIONS

Discount and Acceptance Rates

The various means of credit control and the uses the Federal Reserve Bank of New York has made of them have particular significance. The importance of the New York Reserve Bank in this respect is due to the location of the national and international money markets of the United States in New York City; and also to the centralization of the open market policy of the Reserve system in that Reserve Bank.¹ The various divisions of the general money market in New York are the most sensitive in the country. Thus, discount rate changes have been made more often by the New York Bank than by any of the other Reserve banks.²

Under the Federal Reserve Act the Reserve banks are charged with the duty of establishing from time to time discount rates on each class of paper subject to the review and determination of the Federal Reserve Board. In the beginning the New York Bank had a system of variation in rates according to the type and maturity of paper discounted. In general paper with longer maturities bore higher interest rates, and in practice this meant that agricultural and live-stock paper carried higher rates. This policy continued until June 16, 1921. After this date, at any one time, the Bank charged the same discount rates on all classes and maturities of discounted paper. During the war the Bank discounted paper secured by United States Treasury notes, certificates of indebtedness, or Liberty bonds at lower rates than they loaned on other paper. Within

¹ See chapter VIII.

² Discount Rates of the Federal Reserve Banks, 1914-1921, Government Printing Office, Washington, 1922; Annual Reports of the Federal Reserve Board, 1922 to date.

this class of "bond-secured" paper, beginning with May 22, 1917, discount rates varied for different maturities. This variation continued to February 5, 1921. Since this date such paper, regardless of its type or maturity, has been discounted by the Reserve Bank at any one time at the same rate. The Bank has also since then charged member banks the same rate of interest when they borrowed on their own promissory notes collateralized by government securities or eligible paper as when they rediscounted commercial paper.

As a means of more effectively controlling credit by means of the discount rate, upon the recommendation of the Federal Reserve Board, an amendment to the Federal Reserve Act was approved April 13, 1920. It permitted the Reserve banks with the approval of the Federal Board to establish progressive rates of discount. The progressive rates were assessed against amounts discounted for member banks in excess of their "basic" or "normal" lines, the latter being determined by each Reserve bank uniformly for its member banks.³ The New York Bank did not put this plan into effect. Progressive rates were, however, established by the Reserve banks at Kansas City, Dallas, St. Louis, and Atlanta. After a brief trial they were abandoned by August, 1921, as being a no more effective means of control than some other plans while at the same time arousing much ill feeling.⁴

On the whole it has been the policy of the New York Bank to exert a restraining influence when business and speculative activity appeared to be excessive, and to remove restraints at times of business depression "in the hope that this policy might aid in avoiding the extremes of business expansion and contraction and encourage greater business stability."⁵ In accordance with this policy the Bank has made increases and reductions in its discount rates and its buying rates for acceptances.

During the period of war financing, however, this policy was shelved in favor of one suited to the requirements of

³ Annual Report of the Federal Reserve Board, 1920, p. 58.

⁴ Ibid., p. 59; Hearings on Banking Systems, 1931, pp. 787-789.

⁵ Hearings on Banking Systems, 1931, p. 761.

the emergency as determined practically by the United States Treasury department. From shortly after the beginning of the war in 1917 until the end of the year 1919 Federal Reserve discount rates were fixed at artificially low levels with a view to facilitating the Treasury's fiscal program. In order to supply the Government with sufficient funds, preferential rates were established for bond and certificate-secured paper as compared with commercial paper, and a differential was set in favor of the rate on such bond and certificate-secured paper as compared with the interest rate borne by these government obligations.

The New York Bank has generally altered the discount rates and acceptance rates together, raising them to restrict expansion and lowering them during periods of decline and depression. One important exception to this practice, however, was in August, 1929, when the discount rate and the acceptance rate were changed in opposition to each other. At that time of wild speculation and serious inflation in securities the New York Bank raised its discount rate but lowered its acceptance rate.⁶

Efficacy of Rate Changes

Since the banks have gained access to a large proportion of Federal Reserve credit through the bankers' acceptance market, the acceptance rate has been an important influence on the superstructure of credit. The New York Bank has stood ready to purchase acceptances offered it at the established buying rate for acceptances.⁷ It has not gone into the market and bid for acceptances when purchasing for Federal Reserve account.⁸ On the whole its acceptance

⁶ Annual Report of the Federal Reserve Bank of New York, 1929, p. 7.

⁷ The Bank's purchases, however, depended upon the size of the financial house offering the acceptances to the Bank. In practice this has meant that the New York Reserve Bank stood ready to purchase bankers' acceptances from concerns offering them if those concerns were large enough. See below, p. 248.

⁸ When buying for the account of foreign central banks the Reserve Bank does go into the market to seek acceptances. Although some of the acceptances purchased without going into the market, may be, and on occasion have been, credited to the accounts of foreign central banks.

Federal Reserve officials have made a distinction between the Bank's

rates, which have been primarily the rates for the Federal Reserve system, have been artificially low.⁹ This low acceptance rate has tended to enlarge bank credit unduly and to result not only in "frozen credits" in the portfolios of commercial banks but in non-liquid assets in the Federal Reserve Bank itself.¹⁰ The Bank has not discriminated in the buying rate for acceptances on the basis of the self-liquidating or non-self-liquidating nature of the transaction from which the acceptance arose.¹¹ The acceptance rates have varied only on the basis of length of maturity of the bills.

So far as the discount rate is concerned no discriminatory rates against particular member banks have been in effect in the New York district. The same discount rate has applied to all banks for the same paper at the same time. But by taking the discount rate in connection with the acceptance rate it has been possible for some banks to obtain Federal Reserve credit cheaper than other banks. In particular the group of large banks in New York City engaged in making acceptances and in contact with the acceptance dealers have been the beneficiaries as compared with the other banks in the district. This advantage possessed by the New York City banks was rather strikingly emphasized at the time of the undue expansion of bank credit based on securities in 1929 when the acceptance rate was lowered while at the same time the other banks which handled relatively few acceptances were penalized with a higher discount rate.

The Federal Reserve Bank of New York has stated that in general increased discount rates have tended to check

"taking the initiative" in the case of buying government securities and occupying a passive rôle in the case of buying acceptances, likening the latter to the rediscounting operations of member banks. There is a vital difference, however, between acceptance purchases and rediscounting in their effects on the superstructure of credit, which is the important consideration in this connection so far as the management of central banks is concerned. For a discussion of the differences between the Reserve Bank's acceptance buying and its rediscounting in their economic effects, see Beckhart, *The New York Money Market*, Vol. III, pp. 448-450.

⁹ See Beckhart, *The New York Money Market*, Vol. III, pp. 410-411.

¹⁰ See below, pp. 248-249.

¹¹ *Hearings on Banking Systems*, 1931, p. 920.

credit expansion and lower rates have tended to encourage it.¹² There is a tendency in the New York district on the part of member banks to transfer increases in discount rates to their customers.¹³ This is particularly marked in the financial centers.¹⁴ In addition to the effect of a greater or less cost of bank credit, discount rate changes have a psychological influence which makes them a potent factor in credit control management.¹⁵ In fact, unless a member bank is borrowing from the Federal Reserve bank practically the only effect of a change in the central bank discount rate is psychological. In actual practice, however, discount rate changes have been relatively ineffective.¹⁶ The New York Reserve Bank admitted in effect that its discount rate changes were made too late and the increases were not large enough.¹⁷ Furthermore, the Reserve Bank's practice of lending on the basis of government securities largely prevented its discount and acceptance rate changes from having whatever salutary effect they otherwise would have had.

Development and Influence of Open Market Operations

So far as the relation of Federal Reserve credit to the superstructure of credit is concerned, it was intended in the original Federal Reserve Act that open market operations were to be secondary to rediscounting eligible paper for the banks. During the early years of the system the Reserve banks made relatively few purchases in the open market as compared with later years; although the volume of purchases prior to our entrance into the war was larger than the volume of rediscounts. Such open market purchases as were made prior to 1922 were for the purpose of providing the Reserve banks with earning assets to defray expenses, stimulating the development of an acceptance market, and

¹² *Ibid.*, p. 776.

¹³ *Ibid.*, p. 770.

¹⁴ *Idem.*

¹⁵ *Idem*; Beckhart, *The New York Money Market*, Vol. IV, p. 19.

¹⁶ Willis, *The Federal Reserve System*, pp. 1516-1518; Beckhart, *op. cit.*, p. 19.

¹⁷ *Hearings on Banking Systems, 1931*, p. 766.

meeting technical difficulties in the money market. The element of credit control during this period was not a consideration.

As the system has developed since 1922, the purchases and sales of acceptances and government securities have superseded in importance rediscounting operations. But the significance of this change is considerably enhanced by reason of the fact that during this period open market operations came to be an acknowledged instrument of credit control. Open market operations have practically submergered rediscounting transactions and have become the most powerful factor influencing credit conditions.¹⁸

Open market operations are potentially and have been a powerful influence upon credit conditions because by its own decision the Reserve Bank increases or decreases member bank reserves upon which the superstructure of credit is based. By purchases the Bank increased those reserves and by sales it decreased them. The purchases especially have affected fundamental changes because once the credit superstructure expanded it has been found difficult to bring about its contraction by sales without disturbing repercussions in the nation's economic system. Sales of securities on the part of the Reserve Bank, therefore, have usually resulted in increased member bank borrowings. Member banks have increased borrowings in order to maintain their reserves, thereby sustaining the enlarged volume of bank credit superinduced by Reserve Bank open market purchases.

A Federal Reserve bank is not required to buy acceptances offered it. The Federal Reserve Board in a ruling regarding bankers' acceptances in 1921 said:¹⁹

It should be remembered, however, that there is no obligation upon a Federal Reserve bank to purchase paper offered it, even

¹⁸ See testimony of Dr. A. C. Miller, member of the Federal Reserve Board, before the Senate Committee on Banking and Currency, *ibid.*, pp. 128-132, 150. Several useful studies on Federal Reserve policy have appeared in recent years. One of these, by S. E. Harris, was not availed of by the author inasmuch as this manuscript was completed before that work came into circulation. Dr. Harris has presented, however, a comprehensive treatment of the history of open market operations, particularly in Volume I, Part II.

¹⁹ Federal Reserve Bulletin, June, 1921, p. 699.

though the paper is technically eligible as a matter of law. The Federal Reserve banks have discretionary power, just like any other bank, to decline to purchase paper whenever for any reason that course seems advisable.

And yet on occasion it has been announced in advance that the Reserve Bank would buy a certain amount of acceptances in the following months—a practice inimical to the proper use of central bank reserves. Such an announcement is an open invitation to all sorts of abuses. It means that the Reserve Bank commits itself to the purchase of acceptances regardless not only of whether the acceptances offered meet sound credit tests, but of whether some future factor may make the purchase of some acceptances unwarranted.

From the standpoint of credit control, open market operations are complementary to discount policy. On the whole these operations have ostensibly been used in conjunction with discount rates to force the banks to fall in line with Federal Reserve policy. The New York Bank has made purchases and sales in the open market in order to compel member banks to put into effect a rate and lending policy desired by it.²⁰ When the Reserve Bank desired to make credit easier it bought acceptances and government securities, thereby increasing member bank reserves. When it desired to tighten rates it sold securities, thereby taking funds out of the member bank reserve account.

Type and Effect of Open Market Operations

Although the New York Reserve Bank, by its open market operations, has been particularly successful in preventing short-time disturbances in the money market, smoothing out extremes in interest rates, and in meeting emergencies, the Bank's operations have been scarcely, if at all, successful in the field of credit control. Open market operations have

²⁰ The technique of open market operations and the methods used by the Bank to prepare the way for rate changes were described by Mr. Strong, governor of the Bank, before the House Committee on Banking and Currency in 1926 (see Stabilization Hearings on H. R. 7895, 1926—particularly pp. 307, 330–338) and in the answers to Questionnaire No. 9 (open market operations) published in Hearings on Banking Systems, 1931, pp. 794–840.

commonly preceded changes in the Bank's discount rate and have been supposed to make the latter more effective. Such operations have been so extensive at times that they have resulted in excess member bank reserve balances which contributed to inflation in various markets. Because of the difficulties of effecting a substantial contraction of bank credit, the enlargement of legal reserves in the first place was an important factor in making the open market operations of the Bank ineffectual as an instrument of credit control.

The inefficacy of the Reserve Bank's open market operations has also been due to several other considerations. In the first draft of section 14 of the Reserve Act it had been provided that the Reserve banks could buy direct from individuals, firms, or corporations notes, drafts, and bills of exchange of the kind which the Act made eligible for rediscount.²¹ Opposition to the purchase of notes directly from the maker, however, resulted in the deletion of this power from the Act as enacted. But the framers did succeed in getting into the Act authority for the Reserve banks to buy in the open market not only bankers' acceptances but bills of exchange directly from business concerns. The Federal Reserve Board early formulated rules governing such purchases and advised the Reserve banks concerning their procedure in effecting such transactions.

The policy of the New York Reserve Bank, however, has been to make no purchases of bills of exchange directly from business concerns. These have, at all times, had to go through an intermediary banking institution. Its refusal to apply this traditional central bank power has been defended on the ground that intermediary discount houses needed to be encouraged in order to develop a strong discount market. However, while a strong discount market would strengthen the financial situation, the direct purchase of two-name paper upon occasion need not preclude the development of a healthy discount market. Moreover, there cannot be a strong discount market unless the general credit milieu in which it operates is sound. The first and primary

²¹ Willis, *The Federal Reserve System*, p. 1037.

consideration, therefore, is to have the mechanism at hand to bring the proper influence to bear at the proper time upon general credit conditions to the end that these may be sound and hold the confidence of the public. The Federal Reserve Act provided the mechanism to a degree but the New York Reserve Bank refused to make use of it as intended.

As operated the New York Reserve Bank has had no direct influence on the cost of credit. Its open market operations have been practically confined to bankers' acceptances and government securities. It has been inclined to do nothing whatever to develop the commercial paper market. The older central banks, on the other hand, such as the Bank of England and the Bank of France, have made their rate changes effective by direct dealings with the public in commercial paper. In the United States, however, the New York Reserve Bank has not dealt directly in commercial paper even at times when it wished to make its credit policy effective. The Bank has not purchased bills of exchange from business men without the endorsement of a member bank in those cases in which indirect action through the commercial banks was too slow or lacked sufficient influence. This unwillingness of the Bank to put into effect the open market provision of the Act has been an important factor in the failure of its open market operations at strategic times to have the effect desired and the failure of its credit policy in general.

There have been other factors responsible for the unfavorable effect of the Reserve Bank's open market operations on credit conditions. One of these is its policy of dealing in bankers' acceptances only with the large firms. It has been the practice of the Bank not to buy bankers' acceptances from any dealer whose capital was less than \$1,000,000.²² The consideration in point, however, in determining the financial responsibility element in the credit standing of an acceptance dealer is not the amount of his capital but the ratio of his net worth to his liability on acceptances.

This practice of dealing only with a few big firms has pre-

²² Hearings on Banking Systems, 1931, p. 93.

vented the Bank's credit policy from exerting as wide or strong influence as otherwise would have been the case. Moreover, it has prevented the benefits of the Federal Reserve system from being widely distributed without discrimination to all entitled to them, with adequate credit standing, as was intended by the Reserve Act.

Another factor in the Bank's open market operations exerting an unfavorable influence has been its apparently indifferent attitude regarding the liquidity of acceptances. The Reserve Bank has purchased quantities of acceptances during its existence which were really non-liquid when subjected to the true tests for such paper. Various abuses crept into bankers' acceptances resulting in inflation and a weakening of the banking structure.²³ The chief respects in which the acceptances were non-liquid were that they were based upon unsold commodities and they were renewed either by the same bank or under a system whereby a group of banks in effect renewed each other's acceptances. Furthermore, the Reserve Bank's excessive purchases of government securities at times prior to 1929 resulted in inflationary effects in the stock market.²⁴

Purchase of Paper Directly from Business Concerns

A break in the traditional policy of the Reserve banks of purchasing no paper directly from individuals or business concerns was made as an emergency measure during the recent depression. The Federal Reserve Act was amended by an emergency act of July 21, 1932.²⁵ The amendment empowered the Federal Reserve Board to authorize the Reserve banks, in certain circumstances, to discount for individuals, partnerships, or corporations notes, drafts, and bills of exchange of the kinds and maturities made eligible

²³ Concerning abuses in the use of the acceptance, see Federal Reserve Bank of Richmond, Letter No. 13, pp. 166-167; Willis, *The Federal Reserve System*, chapter XLIV and pp. 1449-1451; Beckhart, *Discount Policy of the Federal Reserve System*, pp. 238-240, 442-449; *Journal of Commerce* [New York], Jan. 2, 1929; *Hearings on Banking Systems*, 1931, pp. 433-463, 841-882; Beckhart, *The New York Money Market*, Vol. III, pp. 320-326, 360-366.

²⁴ See *Journal of Commerce* [New York], Jan. 2, 1929.

²⁵ Public Act, No. 302, 72nd Congress, section 210.

for discount for member banks. No such purchase could be made, however, unless a Reserve bank obtained evidence that the applicant was "unable to secure adequate credit accommodations from other banking institutions."

There had been an excessive number of bank failures in the country, all the banks in many communities having closed. There was also a good deal of dissatisfaction at the time regarding the attitude of the bankers who were hesitant about making loans during the period of falling prices. Apparently the complete absence of banking facilities in some towns together with the critical attitude toward new loans were responsible for enlarging the lending powers of the Reserve banks to include direct loans to the public. Under the amendment, the New York Reserve Bank, in 1932, authorized thirteen direct loans to business organizations totaling \$1,292,500, and made advances thereon.²⁶

As stated above the Reserve Bank had already possessed the right to deal directly with business men under its open market powers ever since its establishment, but had not thus dealt. The 1932 amendment merely added another method of direct contact with the ultimate users of bank credit, that of discounting their notes, although under conditions such as to make it almost impossible for any business to actually obtain such loans from the Reserve banks. The terms of the 1932 statute were such that if a business applicant could secure Federal Reserve credit under it, he could probably secure it from a commercial bank as well. Nevertheless, the Reserve Bank did make contact with business organizations under this emergency amendment and not under its long unused open market powers. As a gesture, perhaps, the New York Bank did deal directly with business men in several cases.

The importance of this step does not turn upon the number and dollar value of the direct transactions, relatively small as they were. The principle of this contact of the New York Reserve Bank with the business public is significant in effecting a departure from the Bank's traditional policy of dealing only with an intermediary financial insti-

²⁶ Annual Report of the Federal Reserve Bank of New York, 1932, p. 24.

tution. Amendments to the Reserve Act, to all intents and purposes incorporated for merely an emergency period, have characteristically taken their place among its fixtures. Further authority, under which Federal Reserve banks may make direct loans to individuals, partnerships, and corporations engaged in business, has been prescribed by Congress in the acts of March 9, 1933 and June 19, 1934.²⁷

Eligibility of Paper for Rediscount

One mechanism for regulating the quantity and quality of credit is that of the rediscounting process. This involves the application of eligibility tests to the items offered for rediscount. The Federal Reserve Board began at the outset to lay down the requirements of eligibility of customers' paper for rediscount at the Reserve banks within the limits prescribed in the Reserve Act. The Board's fundamental requirements, set forth in November, 1914, were designed to raise the quality of paper carried in the average bank's portfolio.

In general the requirements sought to eliminate from the banks much paper that had been responsible for bank suspensions in that it was not based on commercial transactions and was non-collectible at specified dates. Paper of the commercial banking type was to be substituted in the future for such paper as was carried of the investment type. Furthermore, regulations were drawn to insure that the Federal Reserve banks would hold only liquid commercial paper. These requirements were received coldly by the American banking community. It had carried on more liberal credit practices for many years and vigorously opposed the adoption of exacting methods. Consequently the restrictions were modified from time to time to accord more with existing practices.²⁸

In various subsequent regulations the Board has determined the kinds of transactions which could be made the basis for securing central bank credit by the rediscounting

²⁷ Public Act No. 1 and Public Act No. 417, 73rd Congress.

²⁸ See Federal Reserve Board Circular No. 13, Nov. 10, 1914 and Willis, *The Federal Reserve System*, chapter XLII.

process. Within the limits of eligibility set by the Board, the Reserve banks have interpreted the regulations and applied the rules and credit tests to specific items offered by the banks.²⁹ The eligibility, therefore, of any particular item offered by a member bank for rediscount was in the final analysis a matter of judgment of its Reserve bank.

The creation of Reserve bank credit then, has depended upon the degree of strictness with which the eligibility rules were applied by the several Reserve banks. The New York Reserve Bank has been liberal in passing upon the eligibility of paper.³⁰ It has been the practice of the Bank to consider all items offered for rediscount as being eligible unless obviously technically ineligible.³¹

Acceptability of Paper for Rediscount

The Federal Reserve Act, however, does not *require* a Reserve bank to discount all offerings of even eligible paper. It merely says that it *may* discount such paper.³² Whether the Reserve Bank will discount a particular item offered depends upon the acceptability of that item as well as upon its eligibility. The Act further states:

The discount and rediscount and the purchase and sale by any Federal Reserve bank of any bills receivable and of domestic and foreign bills of exchange, and of acceptances authorized by this Act, shall be subject to such restrictions, limitations, and regulations as may be imposed by the Federal Reserve Board.³³

Supplementing the permissive discounting provision of the Act, the Board has recognized the distinction between eligibility and acceptability in one of its regulations pertaining to the discount of promissory notes. This contained the proviso reading:

Unless the statement of the borrower clearly indicates that

²⁹ For a comprehensive treatise on eligibility requirements, theory and practice, consult Willis and Steiner, *Federal Reserve Banking Practice*, chapters VII-XIV.

³⁰ *Hearings on Banking Systems*, 1931, p. 732.

³¹ *Idem*.

³² Federal Reserve Act, section 13.

³³ *Idem*.

such note is both eligible from the legal standpoint and acceptable from a credit standpoint. . . .³⁴

Again, in the Digest of Rulings of the Federal Reserve Board (1928 Edition) the Board states:

Even though paper may be eligible for rediscount, a Federal Reserve bank is under no obligation to rediscount it, but may accept it or refuse it as it is considered desirable from a credit standpoint.³⁵

Since the paper offered by a member bank may be undesirable from a credit standpoint, various credit tests have been applied to the paper by the Reserve Bank to determine its acceptability. These are the borrower's financial standing, his ability to pay, his general business record and reputation, and the value of the endorsement of the offering member bank.³⁶ Unfavorable factors developed as a

³⁴ Regulations of the Federal Reserve Board, Regulation A, section IV, Series of 1928.

³⁵ Federal Reserve Board, Digest of Rulings, 1928 Edition, p. 28.

³⁶ Hearings on Banking Systems, 1931, p. 710. The practice of the New York Reserve Bank in passing upon items offered for rediscount was given in reply to questions put by the Senate Committee on Banking and Currency as follows:

"The credit tests employed by us to determine the acceptability of paper offered for rediscount by member banks are substantially as follows:

"Our first and main reliance is on the indorsement of the borrowing member bank, and we are constantly scrutinizing the value of each bank's indorsement. In addition paper offered by the bank must meet certain tests.

"A statement of the borrower is obtained in all cases where the obligation amounts to \$5,000 or more, and in some instances for less amounts. Reports of commercial agencies covering financial standing, history, and trade reputation of borrowers are obtained on all items of \$1,000 and over, and information is given for all items by the borrowing bank as to business and net worth of the borrower, and use of the proceeds of the note. It is also our custom to obtain information by direct checking with banks and others on names where such a course appears necessary.

"Our credit files are maintained in a manner similar to those of large commercial banks. The net worth of the borrower relative to his debt is taken into consideration and the ratio of quick assets to current liabilities is regarded as an important factor. The borrower's history in active business and the trend indicated by the comparison of statements over a number of years are also considered important.

"We have found it necessary, in passing upon acceptability of paper, to recognize in dealing with individual banks that generally they cannot offer for discount paper of a better quality than their community produces. This is

result of these tests have caused the Bank to turn down eligible paper. But whether because of ineligibility or non-acceptability the amount of paper which the New York Bank has rejected has been a very small proportion of the total paper offered for rediscount by its member banks.³⁷ It is possible for some control over bank credit to be exercised by varying the strictness or liberality with which the credit tests of acceptability are applied. However, as far as its policy is concerned, the Bank states that it does not raise acceptability requirements at a time when it is following restrictive credit policies.³⁸

Loans on Collateral

The intention of the original Federal Reserve Act was to loan on paper on its own strength. This has been modified in two ways: (1) by the administrative practice of requiring excess collateral from borrowing banks, and (2) by the amendment to the Act of September 7, 1916, authorizing a Reserve bank to make advances to a member bank on its promissory note secured by eligible paper or United States Government obligations. The New York Bank has always required a margin of collateral in a limited number of cases.³⁹ In such cases borrowings have been handled "in the form of a collateral note secured by eligible paper equaling at least the amount of the note and also by a margin of additional paper or collateral which need not necessarily be of eligible character."⁴⁰ This practice follows that developed by the large commercial banks in making collateral loans to their "country" correspondents. These banks have been accustomed to require a substantial margin of collateral even especially so in the case of the smaller banks." *Hearings on Banking Systems, 1931, p. 710.*

Consult these hearings, page 732, for further details regarding the rejection of paper.

³⁷ The amount rejected on account of ineligibility and non-acceptability combined for each of the four years, 1927-1930, was less than one per cent. *Hearings on Banking Systems, 1931, p. 732.*

³⁸ *Ibid.*, p. 711.

³⁹ *Ibid.*, p. 712. Concerning the problem of requiring excess collateral see also the same hearings, pp. 103-106.

⁴⁰ *Ibid.*, p. 712.

though the borrowing bank put up securities which were quickly salable in the open market.

The position of the New York Reserve Bank in defense of requiring a margin of collateral has been the prescription in the Federal Reserve Act that loans shall be "safely and reasonably made,"⁴¹ or in other words that loans shall be made in such manner as to assure, as far as possible, that repayment in full will be made.⁴² The Bank stated that it felt impelled in many instances to make loans where surrounding conditions were such as to indicate some possibility of loss; and that in such cases the requirement of excess collateral was an effort to have the grant of credit fall in the category of loans which "may be safely and reasonably made."⁴³

Conditions where a loan to the member bank was not considered unquestionably safe and yet the New York Bank adjudged that its member bank was entitled to a loan upon putting up excess collateral, were outlined by the Bank as follows:⁴⁴

(1) Impaired value of the member bank's indorsement, due to depreciation in its securities account, losses in loans, or other losses which reduce the ratio that its capital funds bear to its liabilities. It is sometimes necessary to extend accommodation to a bank during the period in which steps are being taken by its directors to bring about restoration of the capital account.

(2) Variation in the dependence to be placed on the judgment of the member bank as to the goodness of loans it has made. The paper in different banks may be equally eligible from a legal view point and apparently acceptable from a credit standpoint, but the loss experience of a particular member bank may have been such as to indicate that its paper will show a considerably larger proportion of loss than that of other and better-managed institutions.

⁴¹ Federal Reserve Act, section 4.

⁴² Hearings on Banking Systems, 1931, p. 714.

⁴³ *Idem*.

⁴⁴ *Ibid.*, pp. 714-715.

In 1926, the governor of the Bank testified before the House Banking and Currency Committee that the practice of the Bank was not to take additional collateral in the case of a discount but that such margins were required in the case of 15 day advances in some instances. Stabilization Hearings on H. R. 7895, 1926, p. 544.

(3) The character of the business of the community may be such as to give rise to paper of poor average grade, even though legally eligible and apparently good. In situations of this kind a large volume of the bankers' paper can not be classified either as certainly good or as bad, but required some middle classification. To reject a considerable portion of this would probably be unfair to the member bank, especially as the reserve bank is obliged to form its opinion largely upon the data obtained at secondhand, and does not have the opportunity to have personal contact with borrowers or to observe the daily course of their business as reflected in their current bank account. Ordinarily in cases of this middle classification the member bank's indorsement is quite adequate to make the loan safe, but if the value of that indorsement is impaired for any reason, a margin of collateral becomes important.

(4) Emergency conditions: When a bank is undergoing a run, it is only with great difficulty that it can assemble paper and prepare applications for rediscount rapidly enough to meet the needs of the situation. The difficulty of selecting paper of an acceptable character at such a time is great and to pass upon several thousand items quickly enough to give the needed credit to the member bank is almost impossible for a reserve bank, especially in cases of paper of a borrower whose statement has never before been on file with the Federal reserve bank. In such a case the member bank may meet the situation and receive the needed accommodation by offering a margin on its paper, perhaps using for the purpose of margin, paper or other collateral not of eligible character.

(5) It is necessary to recognize in taking commercial paper from a member bank which is in possible danger of being closed by a run, that in the event of such closing the collectibility of the paper of its customers would be very much impaired, and that many notes which might be paid if the bank were to continue as a going institution might be partially or wholly uncollectible in the event of its closing.

The practice of the Reserve Bank of making loans on excess collateral on member bank rediscounted paper undoubtedly did "protect" the paper. The Bank reported that it had lost no money on its loans to member banks. In case of doubt as to the safety of the rediscounted paper, the Reserve Bank would have the collateral anyway. Also, the loans on collateral have "relieved" certain banks. However, the tendency of such a practice is to lessen the degree of care with which commercial paper is examined by the Reserve Bank before it is rediscounted. Consequently

member banks do not need to exercise the care they otherwise would in making self-liquidating loans. Frozen assets therefore accumulate.

Although lending on excess collateral may help out a hard-pressed bank under any of the above conditions, and while such lending may make the loans unquestionably "safe," and undoubtedly protects a Reserve bank, on the other hand it tends to prevent the proper control of credit. Safeguards, such as the close scrutiny of commercial paper and insistence upon the "commercial" character of the underlying transaction tend to be relaxed in favor of "ample security." The consequence is that bank assets become less liquid than they otherwise would be.

Member bank borrowing on Treasury obligations, begun during the war, continued on a large scale during the decade of the '20s. The Treasury policy of constant refunding of short-term issues at low rates provided bankers with relatively unlimited access to the resources of the central banks. Regardless of whether a member bank held in its portfolio commercial paper,⁴⁵ eligible and acceptable for rediscounting, it could always be assured of drawing on the resources of its Reserve bank if it possessed government securities. Moreover, even though member banks did have eligible paper, they usually borrowed on their own notes collateralized with government securities rather than rediscount the commercial paper because it was more convenient to do so. The New York Reserve Bank stated that "in practically all cases where government bonds are owned, borrowing will be against them before resorting to the use of eligible paper, purely as a matter of convenience."⁴⁶

The New York Reserve Bank also favored the policy of making advances to member banks on their collateralized notes. The Bank has constantly defended this practice as against the testing of commercial credit which it was supposed to do if it was to function in such a way as to maintain the real liquidity and soundness of the banking struc-

⁴⁵ Referring to commercial, industrial, or agricultural paper, within the meaning of the Federal Reserve Act.

⁴⁶ Hearings on Banking Systems, 1931, p. 780.

ture. By this type of lending Federal Reserve officials have relieved themselves of much responsibility. They saw that the government securities behind the member bank notes totaled a certain amount. Such a practice requires far less ability than one which imposes a real credit analysis of specific items of commercial paper. Furthermore, as administered by the New York Reserve Bank the practice resulted in virtually transferring control over the use of Federal Reserve credit to the commercial bankers who utilized United States Government securities for "profit-making" purposes primarily, rather than for the accommodation of commerce, agriculture, and industry.

Whether the proceeds are used for commercial, speculative, or investment purposes, borrowing from the central bank on the basis of government securities is questionable because such securities are of a semi-permanent nature. The policy of making advances collateralized by government securities breaks the close connection between the volume of trade to be financed and the extension of Reserve bank credit. Another defect of the policy was that it interfered with the ability of the Reserve Bank officials to determine the use of credit and regulate it. This is due to the fact that the member bank promissory notes afforded no evidence on their face as to the use to which the proceeds of the loans would be put. Again the result was less assurance that bank assets had the liquidity needed for the bank's deposit liabilities.

The original Federal Reserve Act provided for the rediscounting of commercial paper by having the Reserve banks carefully examine each item offered by the member banks and decline paper which was not self-liquidating and which did not represent commercial as distinguished from investment transactions. These methods which have prevailed of obtaining Federal Reserve credit in ways other than by the rediscounting of short-term self-liquidating paper have rendered more difficult the problem of credit control. The reason for the difficulty is that the practices have removed the direct checks to the unwarranted expansion and use of bank credit involved in the rediscounting of eligible paper

upon the basis of its individual worth. The extent to which the New York Reserve Bank has discounted paper secured by collateral ⁴⁷ instead of relying upon the inherent soundness of the paper itself because of its self-liquidating character indicates how far the Bank has departed from the ideas of the framers of the Federal Reserve Act and the tenets of central banking.

⁴⁷ See *The New York Money Market*, Vol. IV, by Beckhart, Smith, and Brown, p. 385, for the ratio of discounts secured by government obligations to total bills discounted, Federal Reserve Bank of New York and the Federal Reserve System. This percentage has been considerably larger for the New York Bank than for all the Reserve banks combined.

CHAPTER XIII

CREDIT CONTROL—DIRECT ACTION

Persuasion, Curtailment of Non-Essential Loans

Supplementary efforts to control the volume and use of member bank credit and Federal Reserve funds have been adopted. These efforts have included persuasion, warnings, and the refusal to rediscount. It has been the policy of the New York Bank almost throughout its existence to use persuasion¹ as a means of credit control.² During the war and post-war period (1918-1920) the Bank was not able to regulate credit to its satisfaction by discount rate increases owing to the requirements of the Treasury. It therefore resorted to direct action.

The war period involved an effort on the part of Federal Reserve authorities to conserve credit for purposes which were calculated to strengthen the Government in prosecuting the war. The Federal Board, by every means within its power, endeavored to impress upon the Reserve and member banks the need of rationing credit.³ An important medium was the Board's monthly bulletin in which it persistently espoused the attainment of these goals. In the April 1918 issue, the Board made a broad distinction between necessary and unnecessary productive activities; and urged that all unnecessary credits be curtailed and that credit be conserved for the use of the Government.⁴ In July the Board addressed a letter to the Reserve banks asking their support in the campaign, and another letter to all the banks of the country calling upon them to exercise "a reasonable discretion to restrict credits which are

¹ Sometimes called "moral suasion."

² Hearings on Banking Systems, 1931, p. 724.

³ Federal Reserve Bulletin, June, 1918, p. 485.

⁴ Federal Reserve Bulletin, April, 1918, pp. 260-262.

clearly not needed for the prosecution of the war nor for the health and necessary comfort of the people.”⁵

In accordance with the request from the Board, the directors of the New York Bank undertook to further the program in every practicable way. They passed a resolution directing the officers of the Bank to express to the banking institutions of the district the importance and necessity of conserving credit:

By endeavoring to secure such gradual reduction as may be practicable of loans now carried for non-productive or non-distributive purposes.

By gradually reducing the amount of credit granted for purposes not clearly necessary for the prosecution of the war or the health and necessary comfort of the people, and

By educating borrowers of all classes to keep their demands for credit down to the very minimum.⁶

In a letter to all banks in its district, non-member as well as member, the Bank urged the realization of these ends.⁷

Again during the post-war period of inflation the Federal Board and the New York Reserve Bank endeavored to control credit by persuasive measures. The campaign was carried on by informal conversations with bankers, correspondence⁸ and through publications—the Federal Reserve Bulletin and the monthly reviews of the various Reserve banks. A policy of deflation was begun in the fall of 1919 and continued through the early months of 1920 with a view to reducing the volume of bank credit outstanding and prices.⁹ The credit restriction policy was rather sug-

⁵ Copies of these letters may be found in the Federal Reserve Bulletin, August, 1918, pp. 685-687.

⁶ The Commercial and Financial Chronicle, Aug. 10, 1918, p. 552.

⁷ A copy of this letter may be found in the Agricultural Inquiry Hearings, 1921, Part 13, pp. 766, 767. To assist the banks in furthering the program the Reserve Bank prepared two statements for banks to use in enlisting the co-operation of their customers. One statement was for a bank to send alone to a customer. The other statement was to be sent with a letter from the Bank. Thousands of these statements were distributed to the banks and by them to their customers. Copies of them may also be found in the Agricultural Inquiry Hearings, 1921, Part 13, pp. 768, 769.

⁸ Federal Reserve Bulletin, February, 1920, p. 116.

⁹ See Federal Reserve Bulletins, October, 1919-May, 1920; Federal Reserve Bank of New York, Reports on Business Conditions, October, 1919-May, 1920.

gestive at first but gradually increased in forcefulness and involved the rationing of credit on the part of the commercial banks.

The first positive step in the deflation process in the New York district was begun by the New York Bank in January, 1920. It then summoned the heads of several member banks and insisted that they cut down their customers' loans and reduce their indebtedness at the Reserve Bank.¹⁰ The campaign was pushed in its monthly report on business conditions reaching a climax in May, 1920. In its April (1920) bulletin the Bank stated that the Federal Reserve banks and each one of the 30,000 banks of the country "have a special duty and responsibility towards present conditions which they cannot neglect." It held that primary responsibility rested on each banker to do his share by exercising a stricter control of the credit he creates. In answer to the question: "What can the banker do among his customers to exercise a stricter control of credit?" the Bank made the following suggestions: ¹¹

1. Care should be exercised in granting credit to customers whose capital has not been increased proportionately with the increased liabilities of the present day, and who are not setting aside ample reserves against depreciation.

2. A distinction should be made between loans for the purpose of speculating in commodities, securities and real estate on the one hand, and loans for the production and distribution of necessary goods on the other.

3. Avoid loans for the production and distribution of unnecessary goods or for the purpose of carrying stocks of luxuries and expensive grades of goods as such "merely increase the temptation to extravagant living; while loans to individuals to purchase such articles seem wholly undefensible."

4. Business should not be extended for the sake of increased volume of profits. In particular, do not expand plants and equipment but use those existing by installing labor-saving devices or by night work to get larger production without extensions.

5. If extensions of plants and equipment are adjudged necessary they should be financed as far as practicable through conservation of profits.

¹⁰ The Commercial and Financial Chronicle, Jan. 24, 1920, p. 317.

¹¹ Federal Reserve Bank of New York, Report on Business Conditions, April 30, 1920, pp. 1-4.

6. Urge borrowers to pay their debts, reduce present excessive and extravagant consumption, foster systematic saving and sensible spending.

7. Take a more firm and determined stand to prevent further expansion and inaugurate a gradual and orderly restriction of credit.

While the campaign to get the banks to ration credit in the New York Reserve district as well as through the country had some effect,¹² on the whole, its results were most disappointing and must be considered a failure.¹³ There were several reasons for the failure of the campaign for credit rationing. In the first place, bankers found it difficult to distinguish between essential and non-essential uses of credit.¹⁴ Opinion was quite diverse concerning the meaning of the term "essential" and doubtless tended to vary according to the particular interests demanding accommodation at the banks. Also, such a voluntary system depended for its success upon practically all business enterprises having to resort to the banks for financing. Since there were many enterprises of an unessential type which were self-financing and did not rely upon the banks, the method employed did not reach them and was not uniform.¹⁵

Finally, the nature of our banking organization was such as to preclude the success of a vigorous rationing program. With thousands of independent banks, most of which were not members of the Federal Reserve system, closely bound up with the economic and social life of their respective communities, any sincere effort to apply the principle of rationing to a customer was likely to meet with defeat. Any one banker in a community would naturally hesitate

¹² See Federal Reserve Bulletin, August, 1918, p. 685; September, 1918, p. 802; B. M. Anderson, Jr., *Effects of the War on Money, Credit and Banking in France and the United States*, p. 191. Consult also the Federal Reserve Bulletins, January to May, 1920.

¹³ Governor W. P. G. Harding of the Federal Reserve Board, in the *Commercial and Financial Chronicle*, Sept. 25, 1920, p. 1229; Dr. A. C. Miller of the Federal Reserve Board, in the *American Economic Review*, June, 1921, p. 189; Federal Reserve Bulletin, October, 1918, p. 923.

¹⁴ Federal Reserve Bulletin, August, 1918, p. 689.

¹⁵ Federal Reserve Bulletin, October, 1918, p. 923.

to refuse credit on the ground of its being non-essential for fear of losing a customer's business to his competitor. A rationing plan of this type would have had a much better chance of success in a country of relatively few banks with branches.

Warnings

Both the Federal Reserve Board and the New York Reserve Bank have issued warnings. The first public warning was issued by the Board in October, 1915.¹⁶ It concerned the unwarranted use of Federal Reserve credit for speculative loans. In the latter part of 1916 the Board issued another warning with a view to restraining the banks from buying foreign securities.¹⁷ In 1917 the Board called attention to a plethora of net gold imports and the dangers of the continuous and rapid growth of loans and deposits.¹⁸ While the war was on in 1918 it warned against granting unnecessary credits and urged the conservation of credit for war purposes.¹⁹ During the post-war period of speculation and inflation counsel and warnings were repeatedly given by the Board.²⁰ It pointed out the dangers existing in the situation and that Federal Reserve funds were not intended for speculative purposes.²¹ At this time the New York Bank also urged the liquidation of the war investments of the banks and warned member banks that the rediscounting privilege should be exercised only to meet emergency or seasonal conditions.²² It pointed out that at other times they were not to borrow for the purpose of

¹⁶ W. P. G. Harding, governor of the Federal Reserve Board, quoted by H. P. Willis in *The Federal Reserve System*, p. 1335.

¹⁷ *Federal Reserve Bulletin*, December, 1916, p. 661; *The Commercial and Financial Chronicle*, Dec. 2, 1916, p. 2029.

¹⁸ *The Commercial and Financial Chronicle*, Feb. 17, 1917, p. 614.

¹⁹ *Federal Reserve Bulletin*, April, 1918, pp. 260, 261.

²⁰ Dr. A. C. Miller, "Federal Reserve Policy," *American Economic Review*, June, 1921, p. 189.

²¹ *The Commercial and Financial Chronicle*, June 7, 1919, p. 2285; June 14, 1919, p. 2390; July 12, 1919, pp. 102, 130; *Federal Reserve Bulletin*, June, 1919, pp. 523, 524; July, 1919, p. 617; October, 1919, p. 910; December, 1919, pp. 1107-1109.

²² *Federal Reserve Bank of New York, Report on Business Conditions*, Nov. 20, 1919, p. 1.

making a profit over the discount rate²³ and that a reduction of their indebtedness to the Reserve Bank was a condition precedent to the restoration of normal times.²⁴

Warnings were not issued by the Bank during the period of securities inflation and speculation, 1925-1929. The tone of its Monthly Review was different from what it was at the time of the previous inflation. During the "new era" régime it reported facts and statistics regarding rate changes, brokers' loans, and movements of funds in its bulletin. But the New York Reserve Bank did not sound warnings as it had done while the post-war boom was on. The Federal Reserve Board did, however, issue a warning rather late in this "new era," February, 1929, against the use of Federal Reserve credit, directly or indirectly in stock speculation. In a public statement the Board sounded perhaps the most emphatic warning it ever issued, declaring in part that:

The Federal Reserve Board neither assumes the right nor has it any disposition to set itself up as an arbiter of security speculation or values. It is, however, its business to see to it that the Federal Reserve banks function as effectively as conditions will permit. When it finds that conditions are arising which obstruct Federal Reserve banks in the effective discharge of their function of so managing the credit facilities of the Federal Reserve system as to accommodate commerce and business, it is its duty to inquire into them and to take such measures as may be deemed suitable and effective in the circumstances to correct them; which, in the immediate situation, means to restrain the use, either directly or indirectly, of Federal Reserve credit facilities in aid of the growth of speculative credit.²⁵

With this statement was included a letter which it had addressed to the Federal Reserve banks a few days before, giving further warning against the use of Federal Reserve credit for the purpose of maintaining loans on the stock exchange. It read in part as follows:

²³ *Idem.*

²⁴ Federal Reserve Bank of New York, Report on Business Conditions, Dec. 20, 1919, p. 1.

²⁵ Federal Reserve Bulletin, February, 1929, pp. 93, 94. See also Federal Reserve Bulletin, March, 1929, pp. 175-178; Annual Report of the Federal Reserve Board, 1929, pp. 1-4.

The resources of the Federal Reserve system are ample for meeting the growth of the country's commercial needs for credit, provided they are competently administered and protected against seepage into uses not contemplated by the Federal Reserve Act.

The Federal Reserve Act does not, in the opinion of the Federal Reserve Board, contemplate the use of the resources of the Federal Reserve banks for the creation or extension of speculative credit. A member bank is not within its reasonable claims for rediscount facilities at its Federal Reserve bank when it borrows either for the purpose of making speculative loans or for the purpose of maintaining speculative loans.

The Board has no disposition to assume authority to interfere with the loan practices of member banks so long as they do not involve the Federal Reserve banks. It has, however, a grave responsibility whenever there is evidence that member banks are maintaining speculative security loans with the aid of Federal Reserve credit. When such is the case the Federal Reserve bank becomes either a contributing or a sustaining factor in the current volume of speculative security credit. This is not in harmony with the intent of the Federal Reserve Act nor is it conducive to the wholesome operation of the banking and credit system of the country.²⁶

Conflict between the New York Reserve Bank and the Federal Board

The use of Federal Reserve credit in stock speculation brought forth a divergence in policy between the New York Bank and the central Board. The Board addressed a letter to the New York Reserve Bank, February 2, 1929, asking what they had done to stop Federal Reserve credit from going into speculative channels.²⁷ The Board's warning referred to above was made public on February 7th. The Federal Reserve agent of the Bank, Gates W. McGarrah, replied on February 21st to the effect that it had endeavored to get any banks which were "out of line" with other banks to readjust their position but that such a policy was not very effective in controlling the total amount of credit.

²⁶ Federal Reserve Bulletin, February, 1929, p. 94. In its Annual Report for 1928 which was published after these warnings, the Board called attention to the danger resulting from the increase of loans on securities and stressed the responsibility of the Federal Reserve system for limiting the use of Federal Reserve credit in the security markets. Annual Report of the Federal Reserve Board, 1928, pp. 7, 8.

²⁷ Hearings on Banking Systems, 1931, p. 170.

The Board, however, believed that it was the duty of the Reserve Bank to apply pressure to all banks of a group which were borrowing from the Reserve Bank and at the same time loaning money on the stock exchange just as much as when one bank got out of line by borrowing a little more than other banks.²⁸

Accordingly, the Board sent another letter to the Federal Reserve agent of the New York Bank, May 1, 1929. In that letter the Board sent a list of New York City banks which were borrowing continuously or frequently, and which were also carrying quite a large volume of security loans, including brokers' loans and customers' loans.²⁹ The Board requested the Federal Reserve agent to take up the matter with those banks and ask them why they had not adjusted their position in accordance with the Board's warning and why such adjustment was not in accordance with the public interest.³⁰ The Reserve Bank declined to comply with the request of the Board to apply such pressure to the member banks.³¹ In explaining the refusal, Federal Reserve Agent McGarrah told the Board that it was laying down a new procedure to test the abuse of Federal Reserve credit; that it implied the right of a bank to borrow on eligible paper was prejudiced by the fact that that bank is loaning on securities, whereas the banks have a right to loan on securities.³²

Following this reply of the New York Bank, the Reserve Board practically let the matter rest. The Federal Reserve

²⁸ *Idem*.

²⁹ *Idem*.

²⁹ *Ibid.*, p. 171.

³¹ *Idem*.

³² *Idem*.

Mr. McGarrah, himself, while chairman and Federal Reserve agent, was connected with stock market operations in a private capacity. He was, in 1929, a director in a corporation called the Shermar Corporation. The Shermar Corporation was one of six personal corporations formed by Albert H. Wiggin, head of the Chase National Bank, to lessen payment of personal income taxes. Two of these corporations, the Shermar and the Murllyn, developed a short position of 42,506 shares in the stock of the Chase National Bank and were forced to borrow \$6,588,430 from the Chase National Bank to cover that position. This is a specific example of a member bank's stock market loans during this period under question. It also shows a connection which the chairman and Federal Reserve agent of the Federal Reserve Bank of New York personally had with it. Hearings before the Senate Committee on Banking and Currency, Oct. 31, 1933, published in *The New York Times*, Nov. 1, 1933.

Act prescribed that the board of directors of a Reserve bank was to make discounts and advances to member banks "subject to the provisions of law and the *orders of the Federal Reserve Board*."³³ An issue between a Reserve bank and the Board had never been forced to such an extent as to result in a judicial interpretation of the word "orders" in this section. In this case of the use of Reserve credit for stock speculation the Federal Board did not press its stand upon the Reserve Bank. The Board chose not to issue an order compelling the Reserve Bank to do what it sought to have the Bank do by the method of recommendation or exhortation. The central controlling authority had interpreted the Reserve Act one way and the New York Bank had interpreted it another way. Apparently the Board felt that it had made its position clear regarding the restrictions in the Act upon the use of Federal Reserve credit and the consequences of the then existing situation. The Board did not force the issue. Consequently, the position taken by the New York Bank in its interpretation of the Reserve Act continued to prevail and to furnish support for the connection between Federal Reserve credit and stock market speculation.

Efficacy of Warnings

The efficacy of warnings as an instrument of credit control has been very slight. While at times they no doubt have exerted a restraining influence the forces making for expansion have proved too powerful for warnings without any teeth in them to be effective. During the post-war period the checking of inflation by increases in the discount rate was impracticable because of the requirements of the Treasury in putting over its government financing program.³⁴ Relying, therefore, upon direct action, the warnings which were given proved to be "only a transitory expedient and were given only momentary attention by many banks."³⁵

³³ Federal Reserve Act, section 4.

³⁴ Annual report of the Federal Reserve Board, 1919, p. 3; The Commercial and Financial Chronicle, June 14, 1919, p. 2390.

³⁵ Annual Report of the Federal Reserve Board, 1929, p. 12.

Concerning the experience with this type of credit control, Governor Hard-

In the case of the "new era" régime the easy money policy of the New York Bank in 1927 was followed by an unwarranted use of Federal Reserve credit in a wild orgy of speculation in stocks.

Although discount rates were used as an instrument of control the rate increases were tardy and in insufficient "doses" in the early stages of expansion.³⁶ After inflation in securities had proceeded to great heights, the call money rate became king and the Federal Reserve discount rate became secondary and relatively an impotent weapon.³⁷ This was the stage that was reached when in 1929 the Federal Reserve Board decided that the time had gone by when discount rate increases could be effective against securities speculation and could be made without hurting commerce and agriculture.³⁸ In this situation it adopted the policy of direct pressure and issued its warning of February 7th.³⁹

While it may be that the Board's warning restricted the

ing of the Federal Reserve Board said in 1920: "As I have already pointed out, a thorough test was made last year of the theory that the credit situation could be controlled without advancing discount rates, but it was found that control could not be effected by an appeal to reason alone." *The Commercial and Financial Chronicle*, Sept. 25, 1920, p. 1229.

Again, Dr. A. C. Miller of the Board said: "Direct action, so-called, as a method of control was not succeeding. The expansion of credit and the rise of prices went on apace. Speculation flourished." *American Economic Review*, June, 1921, p. 189.

³⁶ Hearings on Banking Systems, 1931, pp. 141, 142.

³⁷ *Ibid.*, pp. 141-144.

³⁸ *Ibid.*, pp. 142, 143.

At the time of the Board's public warning (February 7, 1929) the New York Reserve Bank discount rate had not been raised since July 13, 1928, upon which date it reached 5 per cent. Under the Federal Reserve Act discount rate changes are proposed by the Reserve banks to the Federal Reserve Board for determination. Dr. A. C. Miller of the Board testified before the Senate Committee on Banking and Currency as follows: "The rate was raised by the New York Bank to 5 per cent on the 13th day of July, 1928. It was not until the 14th of February, 1929, or seven months later and one week after the Board issued a public statement to the country with respect to credit conditions, in which was emphasized the dangers inherent in the extraordinary growth in the volume of speculative security credit, that the Federal Reserve Bank moved. It was not until after the Board issued that statement, that the first proposal to raise the rate to 6 per cent was made to the Board." *Hearings on Banking Systems*, 1931, p. 142.

³⁹ See also pp. 265-266.

use of bank credit for trading in or carrying securities below what it otherwise would have been, actually, brokers' borrowings increased after the edict to greater heights than ever before and stock prices advanced.⁴⁰ The Board endeavored to follow up its warning by dealing with the New York Reserve Bank. Its effort, however, to get that Bank to put restrictive measures on the banks, which were using Federal Reserve credit to support their stock market operations, failed.

Uses and Efficacy of Persuasion

The campaign carried on by the New York Bank during the war and post-war years indicates the length to which the Bank went in its effort to control not only commercial banks' lending policies but even the financing policies of business concerns and the economic life of consumers. It was a far-reaching use of the persuasion method of control on the part of a central bank to bring about rationing of credit and deflation. It is a phase of control to which the Bank did not resort during the "new era," 1925-1929, with its over-expansion, inflated stock prices, and mania of installment buying.

Concerning the effectiveness of the use of persuasion as a method of control, the New York Bank stated that "we believe it is impracticable to use moral suasion as an effective part of a program designed generally to restrict or control expansion in or use of Federal Reserve credit" and "we do not believe it is possible for Federal Reserve banks by moral suasion or other means to prevent credit from being used for speculative or investment purposes as distinguished from other purposes."⁴¹ In defense of its stand the Bank explained the difficulties with the use of persuasion as follows:⁴²

The first difficulty is that a principal cause of member-bank borrowings is a loss of deposits which is not connected with loans

⁴⁰ For a comprehensive analysis of various phases of Federal Reserve policy during this period see *The New York Money Market*, Vol. IV, chapters IV-VIII, by Dr. Beckhart.

⁴¹ Hearings on Banking Systems, 1931, p. 725.

⁴² *Idem*.

currently made. In most cases the bank which actually borrows at the reserve bank is not the institution which originally makes the extension of credit resulting in an additional demand for Federal reserve credit. The second difficulty in the use of moral suasion is that it is a personal appeal, the effectiveness of which depends largely upon the human characteristics of the person appealed to. Some bankers are exceedingly anxious to cooperate with the reserve bank and are willing to sacrifice all other considerations to an accomplishment of that purpose. Others resent any suggestions as to how they should run their own business and are but little affected by anything less than the most drastic methods. The great majority of bankers range all the way in between these extremes. It is not possible to present a case to any considerable number of bankers in such a manner as to secure anything approaching uniformity. Moral suasion, if effective, is bound to lead to discrimination, as it merely drives business from the co-operative bank to another less co-operative one. No matter how clear or explicit the expression of policy may be, whether it is communicated by circular letter or by individual contact, the different bankers to whom it is addressed will give it various interpretations, which are likely to be affected by the interests or supposed interests of their respective banks or customers. There is no doubt that much can be done by direct contacts with bank officers, and in cases where the individual bank is borrowing in a manner which requires special treatment the method of direct contact must necessarily be employed. It is a slow operation and, when many banks are to be dealt with, it does not produce results nearly so promptly, effectively, or equitably as does a change in rate. The reasons for a change in rate may not be thoroughly understood by the member banks, but their reaction to it is sufficiently uniform to bring about prompt movement in the direction in which the rate should operate.

The method of persuasion has been used by the New York Bank to influence individual banks with some degree of success.⁴³ Where an individual bank, for one reason or another, appeared to be borrowing either in amounts or for a length of time out of proportion to other banks similarly situated or doing a similar type of business, pressure has been applied to that bank to get it to reduce its indebtedness to the Reserve bank.⁴⁴ This method has also been employed in the case of banks which were using Reserve bank credit as a substitute for capital or were borrowing merely for

⁴³ Ibid., p. 724.

⁴⁴ Ibid., pp. 170, 724.

profit.⁴⁵ Its policy has been not to urge a bank to liquidate its Federal Reserve indebtedness because it was using the credit in a certain way but because its borrowings were out of line with banks in the same community.⁴⁶ Neither has the New York Bank endeavored to persuade its member banks generally or a group of banks in a community not to use Federal Reserve credit for speculative or investment purposes.⁴⁷

There are certain difficulties in determining the use a member bank makes of the proceeds of any *specific* loan.⁴⁸ This is because Federal Reserve credit obtained by whatever means goes into a common pool—the member bank reserve account—which furnishes the basis for a member bank's expansion of loans and deposits as a whole. However, when a member bank makes loans to stock exchange brokers resulting in an increase in deposits and thus necessitating increased borrowings from the Reserve Bank, Federal Reserve credit is used to support the trading or carrying of securities. This is contrary to the intent of the Federal Reserve Act.⁴⁹ And yet, as we have seen, the officials of the New York Reserve Bank have known and are in a position to know the general uses to which member banks put funds borrowed from the Reserve Bank.⁵⁰

Persuasion as a means of credit control has not been successful. The Federal Board's effort to get the New York Reserve Bank to persuade banks supporting stock exchange loans with Federal Reserve funds to reduce the former was a failure. The Reserve Bank did not loan directly on stock exchange paper. What happened was that the stock exchange was supplied indirectly with Federal Reserve funds

⁴⁵ *Idem.*

⁴⁶ *Ibid.*, pp. 72, 724.

⁴⁷ *Ibid.*, pp. 71, 72, 171.

⁴⁸ The New York Reserve Bank has supplied a rather detailed statement of these difficulties. See *Hearings on Banking Systems, 1931*, pp. 715–718.

⁴⁹ The Federal Reserve Act did not prohibit member banks from making investment or stock exchange loans. The prohibition in the Act relates only to their eligibility as a basis for Federal Reserve credit. (See *Federal Reserve Act*, section 13. See also speech of Senator Glass in the United States Senate, *Congressional Record* [unbound edition], May 10, 1932, p. 10197.)

⁵⁰ See chapter XI, p. 238.

with which it could not be supplied directly. The Federal Reserve Act was nullified largely by Reserve bank lending to banks on their promissory notes collateralized by government securities and by open market purchases.⁵¹

Refusal to Discount Eligible Paper

Experience has shown that the particular form in which member banks acquire Federal Reserve funds in no way determines their eventual use.⁵² There is a way, however, in which the Bank could have prevented an unwarranted use of the ultimate reserves of the commercial banking system if it had chosen to do so. That way is by refusing to discount eligible paper or make advances upon the same when those reserves were used for that purpose.

As previously stated, the Federal Reserve Act prescribes that a Reserve bank *may* discount or make advances. It does not say it *shall* or *must* do so.⁵³ This provision of the Act gives the Reserve banks a means of exercising a qualitative control over credit. It enables them to restrict the diversion of Federal Reserve credit into channels not recognized by the Federal Reserve Act. The use of such a method would not result in tightening money for commerce and agriculture. Some of the interior Reserve banks did exercise their authority to decline such an extension of Federal Reserve credit on eligible paper. When they found a member bank was increasing its loans on call they refused to discount any paper for that bank except perhaps for a day or two at a time.⁵⁴ But the New York Reserve Bank did not refuse

⁵¹ See chapter XII, pp. 244-249, 254-259.

⁵² Hearings on Banking Systems, 1931, p. 718.

⁵³ See chapter XI, section on Acceptability for Rediscount.

The general counsel to the Federal Reserve Board and its special counsel, Hon. Newton D. Baker, advised the Board that a Federal Reserve bank has the power to refuse discounts. (Hearings on Banking Systems, 1931, p. 177.) The United States Circuit Court of Appeals for the Second Circuit, in a decision rendered in 1929, stated in effect that it is lawful for a Federal Reserve bank to decline to rediscount eligible paper since such power, under the terms of the Federal Reserve Act, is wholly permissive. (Re: Frank G. Raichle v. Federal Reserve Bank of New York, Annual Report of the Federal Reserve Board, 1929, pp. 35, 36; Federal Reserve Bulletin, August, 1929.)

⁵⁴ H. Parker Willis, "A Turning Point in American Banking," The Banker, London, December, 1928, p. 255.

to discount for member banks on the ground that they were using Federal Reserve resources for stock market purposes. If it declined the discount of any paper presented by one of its member banks it was upon some other ground such as being "out of line" with banks similarly situated.⁵⁵ The logical position in which the New York Bank is thus placed is this: if one bank in a community was "heavily in" the brokers' loan market, it would be appropriate to support it with Federal Reserve credit if the other banks in the community would get in just as deep, or if they had drawn upon the central bank's reserves to support stock exchange trading in about the same degree. The management of the New York Reserve Bank operated in accordance with this policy.

Rationing of Credit

Rationing of credit is another possible method of control. The Federal Reserve Act makes no mention of it nor has any policy of the Federal Board or the New York Bank been particularly "advertised" as such. The efforts of the Federal Reserve Board to prevent the absorption of Federal Reserve funds into the stock market do not comprise rationing since the Board was only endeavoring to prevent the use of reserves in ways it considered illegal under the Federal Reserve Act. Rationing of credit is applicable only to the conversion of credit instruments into exchange media within the limits set by the Act.

As the author uses the term credit rationing involves an effort toward some social end which effort is determined by a high authority and imposed from the top down.⁵⁶ It means that the central banking authorities have a plan, apart from the normal acceptability requirements, in accordance with which they prevent bank credit from going into restricted channels, and facilitate the placing of such credit in lines of which they approve. Thus if several pieces of eligible paper

⁵⁵ Hearings on Banking Systems, 1931, p. 52.

⁵⁶ In a broad sense there is a rationing of credit in the application of credit tests to paper in determining its acceptability for rediscount. But such a procedure is merely the practice of banking in according with sound principles. The procedure here described is something different and is defined as credit rationing.

are offered a Reserve bank, it might choose the underlying transaction or the type of business it will make the basis of a loan and deny it in the case of another. Or again, the Reserve bank might decide upon the amount of credit it will lend and deny credit in excess of this amount to other applicants.

For this purpose the Reserve bank might establish a quota for a firm, an industry, or a trade division and turn down applications in excess of this quota. Central banks are especially fitted to influence the degree of development of any manufacturing industry in so far as that industry obtains its working capital from the banks rather than from the investment market. The central banks are the institutions which possess, or are in a position to possess, a composite record of the status of each industry in the country. Ungoverned by the profit motive and with a comprehensive picture of the "position" of an industry before it, the central banking authority may "ration" credit, and thereby exert its influence toward a balanced economic system.

The nearest approach to credit rationing on the part of the New York Reserve Bank was the campaign in which it engaged during the war and post-war period of prosperity to prevent the creation of bank credit for unnecessary purposes.⁵⁷ This effort was directed to getting the banks and business concerns to avoid the original creation of credit for non-essential and speculative purposes.⁵⁸ The Reserve Bank did not announce that it would engage in or did engage in the practice of credit rationing and presumably it did not do so. There was opportunity for the Bank to do some rationing of credit itself when passing upon eligible paper

⁵⁷ See above, p. 260.

⁵⁸ The Federal Reserve Bank of Atlanta, however, did adopt credit rationing of quite limited scope. It sought to restrict the use of Federal Reserve credit in financing the purchase of "strictly pleasure or passenger automobiles" by refusing to discount paper arising out of such transactions. Although the automobile industry was in an over-expanded condition, and the Atlanta Reserve Bank sought to lessen such a condition, nevertheless, this slight effort at credit rationing was not successful. Pressure from the automobile manufacturers who had cars to sell on the installment plan soon compelled the abandonment of this policy. The Commercial and Financial Chronicle, May 22, 1920, p. 2142.

to determine its acceptability. But the reasons it has given for judging paper non-acceptable have been other than those it enjoined upon the member banks during the war and post-war era concerned. What the Federal Reserve did was to use the method of persuasion to get the member and non-member banks to practice credit rationing. There is reason to believe that the New York Bank itself has never used rationing as a method of credit control.

Enlargement of Federal Reserve Board's Authority

The relative ineffectiveness of the Federal Reserve system to control general credit conditions led to the introduction in the United States Senate, early in 1930, of a resolution calling for a survey of the national and Federal Reserve banking systems.⁵⁹ Pursuant thereto a subcommittee of the Senate Committee on Banking and Currency conducted extensive hearings in Washington in 1931. The hearings covered a wide range of contemporary banking problems, but particular emphasis was placed upon the use of Federal Reserve facilities for trading in and carrying speculative securities.⁶⁰

In the course of the months following the hearings, the chairman of the Committee, Senator Glass, introduced several bills in an effort to secure remedial legislation by Congress. The object of the bills was to bring about the practice on the part of the Federal Reserve Bank of New York and of the Reserve system in accordance not only with the intention, but, in some instances, the literal wording of the Federal Reserve Act. In the House, Representative Steagall, chairman of the Banking and Currency Committee also worked for banking legislation. Thwarted in his efforts time after time, it was not until June 16, 1933, that Senator Glass was able to procure the enactment of a new banking reform bill. This, the Banking Act of 1933, is of

⁵⁹ Senate Resolution No. 71, 71st Congress, 2nd Session, April, 1930.

⁶⁰ Upon the conclusion of the hearings, the banking expert for the committee, Professor H. Parker Willis, prepared a comprehensive report and summary of his findings in regard to bank security loans and investments, brokers' loans and security affiliates. This report was published as an appendix, Part VII, of the *Hearings on Banking Systems*, 1931.

particular significance in this treatise because of its provisions relating to credit control.

It will be recalled that the Federal Reserve Act had imposed upon the Reserve banks the duty of seeing to it that Federal Reserve credit was not used for stock market purposes. This, as has been pointed out, the New York Reserve Bank failed to do with the resulting disastrous effects. We have seen, with particular reference to the New York Bank, that the various means of credit control and the administration of them proved ineffective. Consequently the Banking Act of 1933 sought to strengthen the Federal Reserve Act with a view to safeguarding the credit structure from being weakened by the use of banking reserves for stock speculation. Several provisions in the reform measure of 1933 are for the purpose of restricting the use of bank credit in the investment and speculation markets and effecting greater control over the chief medium of exchange, bank credit.

Section 4 of the Federal Reserve Act formerly read that the board of directors of a Reserve bank *shall*, subject to the provisions of law and the orders of the Federal Reserve Board, extend such credit to member banks as may be safely and reasonably made with due regard for the claims and demands of other member banks. In section 13 of the Federal Reserve Act dealing with the powers of the Reserve banks, one of the provisions of law was that a Reserve bank *may* make discounts and advances to member banks. Under these sections, as was pointed out, some Reserve banks have refused to approve applications for credit and judicial authority has held that the power of rediscount was not mandatory but merely permissive. Nevertheless, the framers of the Act of 1933 apparently wished to reënforce the power of a Reserve bank to refuse a member bank credit by stating in section 4 that the board of directors *may* (instead of *shall*) extend such credit to member banks in the manner stated.⁶¹

Any credit so extended to member banks shall be with due regard for the maintenance of sound credit conditions.⁶² To attain this end the Federal Reserve Board is empowered

⁶¹ Banking Act of 1933, section 3.

⁶² *Idem*.

to issue further regulations; and each Federal Reserve bank is specifically directed to keep itself informed of the general character and amount of the loans and investments of member banks with a view to ascertaining whether undue use is being made of bank credit for the speculative carrying or trading in securities, real estate, or commodities, or for any other purpose inconsistent with the maintenance of sound credit conditions.⁶³ In this connection the right of a Reserve bank to refuse credit accommodation is specifically mentioned, for the new Act says: "in determining whether to grant or *refuse* advances, rediscounts or other credit accommodations, the Federal Reserve bank shall give consideration to such information."⁶⁴

The powers of the Federal Reserve Board are considerably enlarged. The Board, under the new Act, not only has greater control over the several Reserve banks, but at several points its authority extends directly to the individual member banks and includes control over their loan policies. It is empowered to fix from time to time for each Federal Reserve district the percentage of individual bank capital and surplus which may be represented by loans secured by stock or bond collateral with a view to preventing the undue use of bank loans for the speculative carrying of securities.⁶⁵ The Board may also direct any member bank to refrain from further increase of its security loans for any period up to one year under penalty of suspension of all rediscount privileges at its Reserve bank.⁶⁶ Moreover, if in the judgment of the Board, any member bank is making undue use of bank credit for any purpose inconsistent with the maintenance of sound credit conditions, the Board may suspend such bank from the use of the credit facilities of the Federal Reserve system and may terminate such suspension or renew it from time to time.⁶⁷ Still more power to affect

⁶³ Idem.

⁶⁴ Idem. Italics are the author's.

⁶⁵ Ibid., section 7.

This power may be exercised only upon the affirmative vote of not less than six of its members.

⁶⁶ Idem.

⁶⁷ Ibid., section 3.

credit conditions is granted the Board by the Emergency Act of May 12, 1933. Under this Act the Board is given the right under certain conditions to increase or decrease from time to time the reserve balances required to be maintained against either demand or time deposits.⁶⁸

The abuse of Federal Reserve credit by the practice of borrowing on promissory notes, collateralized especially with government securities, can now be prevented by alert Federal Reserve officers. Warnings may be a more effective instrument of credit control for in the future they will have "teeth in them." Should an occasion arise similar to that in 1929, when the Federal Reserve Board was prevented from making its warnings effective by lack of coöperation on the part of the responsible authorities of the New York Reserve Bank, control over an offending member bank automatically resides in the Federal Reserve Board. It is provided that if any member bank to which an advance⁶⁹ has been made shall, during the life or continuance of such advance, and despite an official warning of the Reserve bank of the district or of the Federal Reserve Board to the contrary, increase its outstanding "investment or stock market loans,"⁷⁰ such advance shall be deemed immediately due and payable, and such member bank shall be ineligible as a borrower on its promissory note for such period as the Federal Reserve Board shall determine.⁷¹ Here again the authority of the Federal Reserve Board extends directly to the individual bank.

In other ways the member bank is brought under the direct jurisdiction of the Federal Board. The new banking

⁶⁸ Public Act No. 10, 73rd Congress, section 46.

⁶⁹ This prescription applies to all advances on the promissory notes of a member bank whether such notes are collateralized by government securities or eligible paper.

⁷⁰ The author uses this term to cover the lengthy legal description of the different kinds of loans to which this statute applies. For the technical description of the prescribed loans, see Banking Act of 1933, section 9.

⁷¹ Banking Act of 1933, section 9.

There is one exception to this which states that: "No temporary carrying or clearance loans made solely for the purpose of facilitating the purchase or delivery of securities offered for public subscription shall be included in the loans referred to in this paragraph."

act gives the Board power to remove from office, under certain conditions, any bank director or officer found to have engaged in "unsafe or unsound practices" in the management of a member bank.⁷² This provision may have a tendency to improve general credit conditions in that it is calculated to cause bank directors and officers to exert greater care over the creation of bank credit. It is also the duty of the Board to fix the rate of interest from time to time which member banks may pay on time deposits, thereby giving the Board another means of influencing member bank credit and general credit conditions.⁷³

The extent to which open market policy and operations, and foreign transactions, with their vital influence on general credit conditions, have been brought under the control of the Federal Reserve Board is discussed in other chapters.⁷⁴ We there see in what respects the credit control powers of the Reserve banks and the Board have been clarified and strengthened. Thus it is apparent in view of the extensive and plenary powers, bearing upon the control of credit, delegated to the Board that the Federal Reserve system is now entering upon a new phase of its development. We may witness the expansion and use not only of Federal Reserve bank credit but of member bank credit regulated to a substantial degree by the Board. Since specific means for enforcing its authority have been granted the Board, it is possible that the various methods of credit control available to the central banking system will attain a greater degree of effectiveness than in the past.

⁷² Ibid., section 30.

⁷³ Ibid., section 11(b).

The Act prohibits a member bank from paying any interest on any deposit payable on demand. [Section 11 (b).]

⁷⁴ See chapters VIII and XVI.

CHAPTER XIV

CENTRAL SERVICE FUNCTIONS

Clearing and Collection

In addition to the central banking functions there are several other functions which have been performed by the Federal Reserve banks. These the author designates central service functions. Clearing and collection are, perhaps, the most outstanding central service functions of the Reserve banks. While not necessary to the performance of central banking functions, the Federal Reserve's clearance operations have been a valuable aid in furnishing the central banking authorities with information concerning the movement of funds between various sections. Consequently, the clearing and collection system has been useful in the determination of Federal Reserve credit policies.

A Reserve bank clears and collects for banks in its Federal Reserve district cash claims, consisting mostly of checks drawn against each other. This service has been rendered not only for member banks but, in addition, for so-called non-member clearing banks.¹ In the case of member banks their reserve accounts are used to effect the settlement of claims. In the case of non-member clearing banks, deposits are kept at the Reserve banks for that purpose. A Reserve bank also effects the clearing and collection for banks in its district of their claims against banks in all other Federal Reserve districts. For this purpose the Gold Settlement Fund in Washington, operated by the Federal Reserve Board, is used.

The banks of any one Federal Reserve district send checks directly to their Federal Reserve bank and also to the other Reserve banks in the case of checks drawn on banks in other Federal Reserve districts. A bank receives credit at par for each check it deposits either immediately or after a de-

¹ See also chapter VII, p. 141.

ferred period. The length of the deferred period amounts to one, two, or more days, according to a graduated time schedule.² The time schedule is based upon the time usually required for the mail to reach the bank upon which the check is drawn, and for that bank to make payment at its own Federal Reserve bank. This direct routing of checks together with the settlement of inter-Federal Reserve bank balances by telegraphic advice through the Gold Settlement Fund have been most beneficial. The new methods have done away with circuitous routing of checks, saved much labor and time, and have largely eliminated the float so troublesome during the national banking system era. Also, the par collection system has removed a heavy toll of exchange charges from the commercial and industrial interests of the country.³

Valuable services in facilitating the local clearing and collection of bank claims are also rendered by the New York Reserve Bank. Balances at the New York Clearing House are settled by book entries at the Federal Reserve Bank, thus making it unnecessary to transfer large amounts of money through the streets. The clearing house associations of several other cities in the district also use the Reserve Bank to settle the balances arising from their operations. Settlements are effected by debit and credit entries in the books of the Federal Reserve Bank of New York upon the receipt of telegraphic advice from the clearing house associations. In this way the costly and risky movement of cash through city streets is eliminated or, if drafts were used, a large amount of float and labor is avoided and one or more days are saved in time required for collection. Furthermore, the new method of settlement has resulted in providing the banks with legal reserve funds instead of a check drawn on some other commercial bank.

² Federal Reserve Bank of New York, Time Schedule Circular.

³ For detailed treatment of clearing and collection under the Federal Reserve system, see: Federal Reserve Bank of Richmond, Letters, Nos. 4, 5, 6, 7, and 8, March-October, 1922; W. E. Spahr, *The Clearing and Collection of Checks*, chapters VI, VII, VIII, and XIII; Willis and Steiner, *Federal Reserve Banking Practice*, chapter XX; T. C. Jones, *Clearings and Collections—Foreign and Domestic*, chapter V.

The local clearing association has been expanded in the district to embrace the county. Following the example of the Northern New Jersey Clearing House Association organized in 1920, a number of county clearing house associations have been established and are in operation.⁴ The members of one of these associations send checks drawn on the others direct to them, simultaneously advising the Reserve Bank by telegraph of the amounts. The Bank then clears the aggregate of the claims by making appropriate entries on its books. This arrangement has effected the saving of at least two days in the time required for collecting these items and avoids the necessity of mailing checks to and from the Reserve Bank or correspondent bank. All of the above clearing and collection services are rendered without cost to member banks.⁵

In view of the limited dividend on capital stock of the Reserve Bank and the non-payment of interest on reserve balances it has been the policy of the Bank to be liberal in rendering services to member banks. Non-cash items are also collected for member banks. These consist of notes, drafts, and maturing bonds and coupons. The collection of these items is handled for member banks without charge except such charges as collecting banks may make are passed on to the banks depositing the claims.

During the war the Bank engaged in a foreign collection service for American banks.⁶ At that time insurance rates were abnormally high on shipments of securities across the Atlantic. The New York Reserve Bank made special arrangements with the Bank of England and the British Treasury. Coupons on all British Government securities payable in London and maturing British Treasury securities payable in London were accepted and paid by the New York

⁴ See Annual Reports of the Federal Reserve Bank of New York, 1920, 1921, 1922, 1923.

⁵ During the first few years of its existence, the Bank levied against member banks what it called a "service charge" of one cent per item on checks deposited with it for collection. The charge was imposed to cover the cost of collecting checks. (Annual Report of the Federal Reserve Bank of New York, 1915, p. 9.) These service charges were, however, abandoned on June 15, 1918. Annual Report of the Federal Reserve Bank of New York, 1918, p. 7.

⁶ Federal Reserve Bank of New York, Circulars 107, 135, 298, and 461.

Reserve Bank. This service was announced July 6, 1918, and continued until June 30, 1922.⁷

Domestic Exchange

In addition to the domestic transfer of funds through the collection of checks, the Reserve system has effected a remarkable improvement in furnishing domestic exchange. The Reserve banks have transferred funds to and from their member banks by mail or telegraph between any cities or towns in the country.⁸ By the use of drafts and telegraph orders any member bank in the country may obtain through its Federal Reserve bank an exchange service comparable to what it would secure if it had an account in each of the twelve Federal Reserve banks.

The Federal Reserve system has served non-member clearing banks in the same manner. Funds are transferred only upon the request of the member or non-member clearing banks. However, other banks which are correspondents of either member or non-member clearing banks also, through them, have the privilege of utilizing the facilities of the Reserve system. But the value of the Reserve system in supplying domestic exchange is not confined to the banks. Business organizations as well benefit from the system. Though the Reserve banks will not deal with business concerns and make transfers to them directly, the latter may have funds transferred to other business concerns or banks by getting their banks to do it for them.

⁷ In discontinuing this service the New York Reserve Bank said:

"As the conditions which led to the adoption of these arrangements no longer exist, and as adequate facilities for the encashment of coupons from British Government securities are now available through ordinary channels, there is no longer any necessity for our continuing this special service. For your information it may be said that there is a market for the sale of these coupons for cash in New York, and they may be readily disposed of in that way, or they may be collected through those banks and bankers which deal in foreign exchange." Federal Reserve Bank of New York, Circular 461, May 23, 1922.

⁸ Federal Reserve Bank of New York, "Transferring Funds under the Federal Reserve System," Monthly Review, June 1, 1921; Federal Reserve Bank of Richmond, "Federal Reserve Exchange," Letter No. 17, September, 1924, and "Telegraphic Transfers," Letter No. 19, July, 1926. Consult also: Ira B. Cross, Domestic and Foreign Exchange, chapter III; W. E. Spahr, The Clearing and Collection of Checks, pp. 206-217.

All drafts sent by mail are payable upon presentation at par for immediate credit. The total transfers by mail have been insignificant in amount, most of them having been made by telegraph. The settlements between Federal Reserve banks are effected by telegraphic advice through the Gold Settlement Fund operated by the Federal Reserve Board. For this service the Federal Reserve system leases a network of private telegraphic wires, under its own control and operated in its own offices, the messages being usually in code. Any excess reserves of a member at the New York Reserve Bank may be made immediately available to any other Federal Reserve bank or member bank in the New York or any other Federal Reserve district. Transfers within New York City take place also by messenger and through the clearing house.

Telegraphic transfers have brought about the immediate transfer of funds at par. Moreover, this telegraph service is rendered free of charge to the banks. Physical shipments have been practically reduced to the supplying of currency and coin to member banks for use as till money, and the return of any excess till money to the Reserve banks. Domestic exchange has thus been made available in every part of the United States and without the payment of any premium.⁹ A trying inconvenience and a large financial burden has been taken from the banks and business of the country.

Currency, Coin, and Gold Bullion

Commercial banks ordinarily keep enough vault money on hand to take care of only their minimum requirements. But every day there are some banks requiring additional cash, or in need of exchanging unclean and mutilated notes or of securing other kinds or denominations. The Reserve banks have met these needs of the member banks for currency and coin. When member banks have wanted gold bullion for export purposes the New York Reserve Bank

⁹ When the Reserve banks first transferred funds for business concerns they did it gratis. Later on such transfers became so extensive that the Federal Reserve leased telegraph lines became over-crowded and the Reserve banks charged for the telegraph service on behalf of business concerns.

has supplied it, subject to any restrictions imposed by the American Government during a period of embargo. The Bank has supplied demands for currency for the most part by issuing Federal Reserve notes. But it also furnishes all the other kinds of money in circulation, paper and metallic. The member banks have been supplied in good times and bad and so have been enabled to meet the needs of business.

No bank in the United States has failed because it could not convert its balances at the Reserve bank into cash, or indeed its balances in the commercial banks in New York. The latter have always been able to obtain funds from the New York Reserve Bank for the purpose of supplying the needs of their bank clients. Moreover, any bank having satisfactory paper could always obtain accommodation for legitimate purposes or get currency to pay depositors who wanted money, except during the bank holiday. The banks do not need to borrow in order to obtain circulation from the Reserve banks as it may be charged against their balances in excess of the amount required for the reserve. The danger of a run on a solvent bank is minimized since, if there are no excess reserves, the bank may acquire them by borrowing or selling some of its assets, provided, of course, that what it has to offer is acceptable.

A service for the conversion of Canadian paper money into United States currency was begun in April, 1930.¹⁰ Formerly, the discount in the United States on Canadian currency brought in by travelers frequently ranged as high as 10 per cent and sometimes 20 per cent at places remote from the border. This situation gave rise to some feeling in Canada, especially since United States currency was generally accepted at par in Canada. Such high discounts were regarded as excessive by the Federal Reserve Board and arrangements were made to lower them to the banks so that they could lower them to merchants receiving Canadian currency. Member banks may include Canadian currency, properly segregated, with their shipments of United States currency to the Reserve bank. Upon receipt the Reserve bank converts it into United States funds and

¹⁰ Federal Reserve Bank of New York, Circular No. 973.

credits the proceeds to the member bank's reserve account.¹¹ The Federal Reserve banks absorb the cost of shipping the Canadian currency from the member banks to their respective Federal Reserve banks. But they deduct an allowance to cover the actual exchange charges, and insurance and shipping charges, if any, from the Federal Reserve banks to the points of conversion into United States currency. For three years the average cost of converting Canadian currency into United States funds, including both exchange and shipping charges, averaged less than 1 per cent.

Bank Runs and Suspensions

Although the Federal Reserve system has minimized the danger of bank runs there have been occasions when bank runs or suspensions have threatened and the Reserve banks have been of service. One such occasion was in a foreign country but the Reserve system was involved because of the interests of member banks there. Confidence in the banks in Cuba, in 1926, was seriously impaired and widespread runs had started in various parts of the island. The New York Reserve Bank figured in this, being of much service not only to New York City member banks but to another part of the United States and a foreign country as well.

Member banks in New York City had a number of branches in Cuba and wished to send currency to them. The currency, amounting to some \$27,000,000, was sent to those branches through the New York Reserve Bank.¹² The Bank transferred the funds to the Federal Reserve Bank at Atlanta by telegraph. The Atlanta Bank shipped the actual cash, Federal Reserve notes, by a special train and boat to Cuba. As a result the bank depositors in Cuba were paid, the alarm subsided and the runs stopped. The arrangements and arrival of the currency in Cuba were all effected between the time of closing the banks on Saturday and their opening Monday morning. The transaction re-

¹¹ In April, 1930, such conversion was effected by sale in New York at the current market rate. Federal Reserve Bank of New York, Circular No. 973.

¹² Stabilization Hearings on H. R. 7895, 1926, pp. 477-478.

sulted in a depletion of the New York member banks' reserve accounts of \$33,000,000,¹³ which they made up by borrowing from their Reserve Bank. The New York Reserve Bank again enters the picture. The shipment of \$27,000,000 of Federal Reserve notes so reduced the cash resources of the Atlanta Reserve Bank that it had to replenish them. The New York Reserve Bank supplied the funds by buying \$14,000,000 worth of securities from the Atlanta Reserve Bank, payment and receipt being effected by debit and credit entries on the books of the Gold Settlement Fund.¹⁴

So far as its out-of-town member banks are concerned, the New York Reserve Bank has been of service in a wide variety of troubles. Information regarding the financial condition of the banks comes to the notice of the Bank in various ways: through the official bank examinations, banking operations with them, visitations of the Bank's officers and members of the staff of the Member Bank Relations Department, and particular reports concerning some unfavorable development or unfortunate occurrence. There have been many cases of banks being weakened by heavy withdrawals where the Reserve Bank has rendered immediate service which had an undoubted effect in restoring confidence and ending the withdrawals.¹⁵ This was accomplished by the advice and coöperation of the Reserve Bank's officers and the bank examiners, the extending of credit and the sending of an ample supply of currency. When the New York Bank has received word of a run on a member bank it has sent a man with currency by the first train.¹⁶ In some other Federal Reserve districts, the central banks have used airplanes and motor cars to speed money to distressed banks.¹⁷ During an influenza epidemic all the officers of one bank and nearly all its clerks and directors were stricken with influenza. The Reserve Bank sent a force of

¹³ This was the amount the New York Reserve Bank telegraphed to the Atlanta Reserve Bank for the account of the banks that ordered the currency shipped to Cuba. *Ibid.*, p. 478.

¹⁴ *Idem.*

¹⁵ Annual Report of the Federal Reserve Bank of New York, 1920, p. 45.

¹⁶ Stabilization Hearings on H. R. 7895, 1926, p. 480.

¹⁷ *Idem.*

men to run that bank until its staff recovered. Bank buildings have burned down and bank vaults would not open. In such cases the Reserve Bank rushed money to them to keep them going.¹⁸

Acceptances and Government Securities

Other central service functions rendered by the Reserve banks involve acceptances and government securities. The New York Reserve Bank offers a special acceptance service to its member banks. When a member bank's reserve balance is above the legal requirement the Reserve Bank will buy interest-bearing acceptances. It has purchased for the banks acceptances on their order either for particular bills or for an approximate amount of bills of certain maturities. In the latter case the acceptances have been such as the Bank has purchased for its own account, three-name paper bearing a bank endorsement other than that of the acceptor. The acceptances have been held in the custody of the Bank, sold when desired, collections made on them at maturity or disposed of in other ways as directed. These services are rendered without charge. The Bank has thus made it easy for members to keep their funds profitably employed at all times in acceptances.

Government obligations are also bought and sold pursuant to definite instructions from member banks. Bonds and certificates of one issue are converted into those of another. The Bank supplies all banks in the Federal Reserve district with descriptions of new issues and receives subscriptions for the same. It will transfer certain types of United States Government securities for and to a member bank by means of the wire transfer system—no physical shipment of them being necessary. For this purpose, the Reserve Bank has had on hand a supply of unissued government securities. If a certificate of indebtedness is sold in San Francisco for delivery to a party in New York it may be turned in at the Federal Reserve Bank of San Francisco and canceled there. Upon receipt of a code telegram the

¹⁸ Ibid., p. 547.

New York Reserve Bank will deliver a new one in New York and thus save the risk and expense of shipment across the country.¹⁹ This process is accomplished with the aid of the Commissioner of Public Debt at Washington, D. C. During the war and post-war years the Bank collected coupons on British Government securities and matured British Treasury bills and war expenditures certificates.²⁰

Another service is that of safekeeping of securities. This is limited to securities owned by member banks. The country banks particularly find the custody service convenient and economical because (1) the securities are already at the Bank in case they wish to use them as collateral for borrowing and, (2) sales may be made to the Reserve Bank or others and funds received more quickly. Commencing in July, 1929, the Bank's security service was perfected as a result of becoming a clearing non-member of the Stock Clearing Corporation of the New York Stock Exchange.²¹ The Bank furnishes quotations and it will give advice upon request. While most of the securities involved are government, the security service has not been confined exclusively to treasury issues.

The Reserve Bank now effects receipts and deliveries of stocks for the account of member banks through this corporation at the Stock Exchange. The system involves principles and methods similar to those utilized in the clearing of checks. The corporation conducts a central delivery department and the clearing institutions make settlement by paying or receiving the net balance due to or from the Stock Clearing Corporation. As a result of a careful study of the matter by the Reserve Bank it was determined that this system provided substantial improvement in service to member banks from the standpoint of both safety and convenience.²² The delivery and settlement of non-clearing stocks, bonds, curb and over-the-counter stock are not included in this new system.

¹⁹ Ibid., pp. 540, 896-897.

²⁰ See above, p. 283.

²¹ Federal Reserve Bank of New York, Circular No. 922.

²² Idem.

Miscellaneous

When the Federal Reserve collection system was being introduced many member banks in the district did not join it because they were reluctant to give up exchange charges from which they had customarily derived a substantial income. In order to secure their coöperation and assist them in making a rational decision, the New York Reserve Bank experts made studies of the income, expenses, and methods of a number of typical member banks in the district for the purpose of seeing what economies might be effected or additional sources of income developed and by what methods.²³ As a result of the analyses, the expense of which was borne by the Bank, it developed a method for analyzing depositors' accounts adapted to the average bank's business, by the use of which the net profit or loss arising from each account could be determined.²⁴

The Reserve Bank recommended and urged upon member banks methods of offsetting any losses arising through the use of the Federal Reserve collection system. It advised that each depositor's account be put on a paying basis by (a) maintaining a compensating balance, (b) paying a regular monthly charge for the bank's service, or (c) paying a definite amount for each check used.²⁵ It also pointed out the possibility of increasing earnings by withdrawing and loaning at home funds they had formerly kept with collecting banks.²⁶ Furthermore, the Bank sent to a number of country banks a junior officer who explained methods of analyzing deposit accounts and generally discussed with the bankers the changes recommended.²⁷

The Bank has encouraged the practice of requiring financial statements in order to establish higher standards of banking. In order to assist member banks to assemble and maintain credit information relating to borrowers it distributed four types of forms to member banks, one for each

²³ Federal Reserve Bank of New York, letter to member banks, April 20, 1915.

²⁴ Federal Reserve Bank of New York, Analysis of Depositors' Accounts.

²⁵ Federal Reserve Bank of New York, Circular No. 46.

²⁶ Annual Report of the Federal Reserve Bank of New York, 1916, p. 22.

²⁷ *Idem*.

of the following classes of borrowers: corporations, firms, farmers or live-stock dealers, and merchants, manufacturers, or other individuals.²⁸

The Bank makes for its member national banks all deposits required of them on account of the 5 per cent redemption fund held by the Treasurer of the United States for redeeming national bank notes. The deposits are finally effected by the Treasury department in Washington by making transfers from the gold redemption fund of the Bank against Federal Reserve notes, the Treasury having custody of both redemption funds.²⁹

Member banks were supplied with a method for analyzing their reserve accounts by the use of which the required reserve and the available reserve balance for each day could be determined.³⁰ Information concerning principles and methods of exercising new functions which the Federal Reserve Act conferred upon the Reserve Bank and commercial banks has been freely given, such, for example, as the trust and acceptance functions. Beginning with October 28, 1914, the Bank has issued over one thousand circulars to its members and sometimes all banks in its district, pertaining to matters of common interest and concern. Circular No. 2, October 31, 1914, said:

This circular is sent to member banks in accordance with the desire of the directors of the Federal Reserve Bank of New York that they should be kept fully informed from time to time of the steps which have been taken in its organization and of all matters of general interest to them in connection with its operation and policies.

Now and then, also, pamphlets of an informative or scientific character have been distributed gratis to its member banks.³¹ One pamphlet, "Better Banking," which was

²⁸ Federal Reserve Bank of New York, Circular No. 29.

²⁹ Annual Report of the Federal Reserve Board, 1922, p. 28.

³⁰ Federal Reserve Bank of New York, Circular No. 207.

³¹ Examples of such have been: Current Operations of the Federal Reserve Bank of New York as Fiscal Agent of the United States; Organization Manual of the Federal Reserve Bank of New York; The Ratio of Bank Capital to Deposits; Recommendations of the Bureau of Standards of the United States Department of Commerce as to the Standardization of the Size and Arrangement of Bank Checks and Other Forms; Laws Affecting the Federal Reserve

descriptive of banking operations under the Federal Reserve system, was offered to member banks at one cent a copy to cover the cost of publication. The banks distributed it to their customers, usually with the name of the member bank printed on the cover.³² The Bank has published a monthly bulletin of information and statistics called "Monthly Review of Credit and Business Conditions," which is distributed to member banks and others interested. It was first issued in September, 1919, but prior to this a bulletin called "General Business Conditions," was issued from January 2, 1918 to August 15, 1919. The latter bulletin was the outgrowth of a monthly report which the Federal Reserve agent sent to the Federal Reserve Board, commencing in 1915. The current bulletin has contained a monthly summary of monetary, banking, and business developments based upon statistical analysis and personal inquiry. The New York Reserve Bank's monthly review is received not only by its member banks but by banks and other interested parties all over the United States and the world.³³

On the tenth floor of its building in the financial district, at Liberty and Nassau Streets, special rooms are provided for the use of member bankers. These rooms have been the scene not only of "routine" and informal meetings of bankers but of "star-chamber" sessions lasting most of the night when financial problems of extraordinary consequence were argued. Occasionally special series of formal conferences have been held at the invitation of the Bank for the purpose of realizing greater coöperation in the policies and operations of the Federal Reserve system.³⁴

Officers of the Bank have, throughout its history, customarily attended bankers' conventions and group meetings not only in the New York district but in other districts and have commonly addressed such gatherings.

and Regulations of the Federal Reserve Board; Report of the Committee on Bank Reserves of the Federal Reserve System.

³² Up to the end of 1922, the number of copies purchased from the New York Reserve Bank was 667,000. Annual Report of the Federal Reserve Bank of New York, 1922, p. 32.

³³ The monthly circulation of the bulletin has been as high as 42,000.

³⁴ Annual Reports of the Federal Reserve Bank of New York, 1919, p. 28; 1921, p. 30; 1925, p. 18.

Member Bank Relations Department

When the pressure of operations involved in financing the war subsided a concentrated effort was made by the officers of the New York Bank to establish personal relations with officers of member banks. When the functional organization was effected in 1919, a new department was installed, the Member Bank Relations Department,³⁵ devoted distinctly to this service. Early in 1919 a special representative of the Bank was delegated to visit member banks, make personal contacts with their officers, explain the services of the Reserve Bank and the rules and regulations of the Federal Reserve Board, discuss their problems and point out how the Reserve Bank could help in solving them. This service proved to be so beneficial that when the Member Bank Relations Department was organized, several men were assigned to it for such work. Ever since then this department has had a number of traveling representatives who have spent practically their entire time going about over the Second Federal Reserve District, calling upon the officers of banks, instructing them and advising with them.

It has been the policy to visit every member bank in the district at least once a year. A record has been kept on each bank of all matters coming up between it and the Reserve Bank during the year. When the call on the bank was made these have been discussed.³⁶ While most of this work has been with member banks many non-member banks have been visited and a similar service has been rendered them so far as their status permitted.³⁷ Altogether, thousands of visits have been made. The work of this department has aided the banks materially in utilizing to a fuller extent the opportunities offered by the Federal Reserve system.

The Buffalo Branch

The member banks in New York City have advantages which the country banks in the district are not in a position

³⁵ Annual Report of the Federal Reserve Bank of New York, 1919, p. 28.

³⁶ Stabilization Hearings on H. R. 7895, 1926, p. 560.

³⁷ For example, in the month of April, 1930, representatives of the Reserve Bank made 379 visits to banks, 259 to member banks and 120 to non-member banks.

to enjoy. Their checks and other claims can be cleared and collected more quickly, thus making Reserve bank credit available to them for use sooner. They can secure currency more quickly. Hence they can have more funds drawing interest because they do not have to have as much vault cash with which to conduct their daily business. They also have greater protection against runs and therefore a feeling of greater safety, and more peace of mind, in the knowledge that the Federal Reserve Bank is "right across the street." Furthermore, the officers of the New York City member banks are in a position to maintain close personal contact with the Federal Reserve Bank officials. They, therefore, may effect a greater coördination of their policies and receive such benefits of information and counsel as may be secured in conversation with them, all of which should be conducive to a more enlightened conduct of their affairs.

It was to make available to all member banks in a district more complete and satisfactory service, comparable to that enjoyed by the banks in Federal Reserve bank cities, that the Federal Reserve Act provided for the establishment of branches of Federal Reserve banks.³⁸ In the New York Federal Reserve district the matter of opening a branch to serve the western counties of New York State proceeded in an unhurried manner. It was not until May, 1919, that a branch of the Federal Reserve Bank of New York was opened for business in the city of Buffalo.³⁹ The ten western counties of the State were assigned to the Buffalo Branch.⁴⁰

There are, in a general way, two types of Federal Reserve branches. There are those which act more or less independently under the direction of their boards of directors, and carry on nearly all the functions exercised by the Federal Reserve banks. The others are quite confined in their operations, and either do not carry on some of the more important Reserve bank functions or exercise them only on specific authority from, or for the account of their Reserve

³⁸ Federal Reserve Act, section 3.

³⁹ Annual Report of the Federal Reserve Bank of New York, 1919, p. 39.

⁴⁰ See chapter III, p. 60.

bank.⁴¹ The Buffalo Branch is in the former group. It carries the reserve accounts of the member banks located in its territory and the clearing accounts of non-member banks. Eligible paper presented by member banks is discounted by and carried on the books of the Branch, subject to review, however, by the Reserve Bank. The Branch clears and collects checks, drafts, and other cash items collectible at par through a Federal Reserve bank, and receives for collection and credit, on its own books or on the books of the Reserve Bank, maturing bills, notes, coupons, acceptances, and bill of lading drafts.

The Branch also makes telegraphic transfers of funds for the account of member and clearing non-member banks and participates directly in the daily clearing through the Gold Settlement Fund. It maintains custody services as (1) collateral pledged as security for rediscounts and member banks' collateral notes, (2) collateral pledged by member banks as security for government deposits, (3) securities held for the account of the fiscal agency department, United States Treasury, and (4) securities held in safekeeping for member banks. A supply of currency and coin is kept to meet the requirements of banks in its territory. As far as its relations with the Treasury are concerned, government deposits are received and transmitted to the New York Bank, government checks and coupons are paid, government obligations are exchanged and those matured are redeemed, and subscriptions are received for certificates of indebtedness and Treasury notes. In the matter of open market operations the Branch is restricted. Acceptances and United States Government securities are not purchased in the open market except upon specific instructions from New York and when so purchased are carried on the books of the New York Bank.

The Federal Reserve Board has pointed out the impracticability of establishing branches in relatively large cities merely to gratify civic pride.⁴² It has also been reluctant to increase the number of branches for the reason that "they

⁴¹ There are now 25 branches and 2 agencies of Federal Reserve banks in operation. Most of them are of the first type mentioned.

⁴² Annual Report of the Federal Reserve Board, 1919, p. 39.

add materially to operating costs." ⁴³ On this question the Board commented thus:

Most of the branches now in operation were established during or immediately following the war period when there seemed to be very good reasons for going to the expense of maintaining branches in the cities in which they were established. There is some doubt now, however, as to whether or not the greater promptness with which member banks in certain Federal Reserve branch cities may now avail themselves of the services of the Federal Reserve bank is of sufficient importance to warrant the additional cost to the Federal Reserve bank of maintaining the local branch. It may be necessary, therefore, at some time in the future to give serious consideration to the advisability of discontinuing certain of the existing Federal Reserve branch banks. ⁴⁴

While there has been no effort to discontinue the Buffalo Branch, there is reason to believe that as long as the territory of the Second Federal Reserve District remains substantially as at present, the New York Reserve Bank will not have more than the one branch. Early in its history the Federal Reserve Board adopted the policy of having the Federal Reserve banks pay all costs involved in shipping money to and from the member banks, thus bringing about much greater equalization of Federal Reserve advantages as between banks. Since the establishment of the Buffalo Branch, any bank in the district may be reached from its respective central service point, New York City or Buffalo, over night. The increasing costs of maintaining on a business basis any additional branches in the district tend to prevent their establishment.

So far as inequalities due to differences in location are concerned, the work of the Buffalo Branch has been of considerable service in bringing about a greater equalization of benefits among all banks in the district. The extent of the advantages enjoyed by member banks in New York City over out-of-town banks, referred to above, would be much greater were it not for the branch in western New York. It has been the policy of the Federal Reserve Board to consider the Federal Reserve districts as units and to hold the

⁴³ Annual Report of the Federal Reserve Board, 1922, p. 26.

⁴⁴ *Idem*.

Reserve banks to full responsibility for all operations in their respective districts.⁴⁵

Examination

The original Federal Reserve Act required at least two examinations each calendar year of every member bank, state as well as national, to be made under the direction of the Comptroller of the Currency, and the submission of reports of condition and of the payment of dividends to that officer.⁴⁶ It also provided, however, that the Federal Reserve Board might authorize an examination of state member banks by state authorities accepted as satisfying the requirements. Furthermore, the member banks were subject to such additional special examinations as the Federal Reserve Bank or Federal Reserve Board saw fit to make.

The state institutions did not like the idea of being under the jurisdiction of the Comptroller of the Currency or the Federal Reserve Board in such matters and this was one of the factors which made them reluctant to join the Federal Reserve system. Hence in the Act of June 21, 1917, was included an amendment providing that while the examinations are subject to the direction and approval of the Federal Reserve Board, "whenever the directors of the Federal Reserve Bank shall approve the examinations made by the state authorities, such examinations and the reports thereof may be accepted in lieu of examinations made by examiners selected or approved by the Federal Reserve Board." This Act also provided that reports of condition and the payment of dividends be made to the Federal Reserve Bank. These are the legal requirements in effect at the present time.

As far as national banks are concerned close coöperation has been maintained between the Reserve Bank examiners and the national bank examiners for the New York Federal Reserve district,⁴⁷ who, in fact, have their offices in the building of the Federal Reserve Bank of New York. The

⁴⁵ Annual Report of the Federal Reserve Board, 1917, p. 25.

⁴⁶ Federal Reserve Act, 1913, sections 9 and 21.

⁴⁷ Annual Reports of the Federal Reserve Bank of New York.

Reserve Bank examiners have examined some national banks independently and have participated in examinations jointly conducted with representatives of the office of the Comptroller of the Currency. Copies of the reports of examinations by national bank examiners have been furnished the Bank.

The Reserve Bank examination department has worked in close coöperation with the state banking commissioners. The Bank has generally accepted an examination report of a state institution made by the respective banking department of the states of New York, New Jersey, or Connecticut. The reports have usually been approved without supplementing them with an independent investigation of its own. In some cases, however, the reports have been supplemented by the work of the Reserve Bank's own examiners. Special examinations have been made by the Bank of state institutions applying for membership. In the case of the regular periodical examinations, the Reserve Bank may conduct and often has conducted joint examinations with the state bank examiners.

The conflicting examination authorities of the state banking departments on the one hand and the national bank examiner's office on the other have been a disturbing factor in the successful development of the Federal Reserve Bank's examination function. Some progress has probably been made by the Reserve Bank in bringing about standards more uniform as between the state and national authorities so far as the technical examination is concerned. But this is of secondary importance since the state and national laws upon which the respective examinations are based are different and therefore result in competition between state and national banking interests for a lowering of banking standards.

As was pointed out in a previous chapter ⁴⁸ the Federal Reserve agent has had charge of the Reserve Bank's examination function. He is "on the ground" and it had been supposed would be in a particularly advantageous position to look out for the interests of depositors in member banks.

⁴⁸ See chapter V.

The agent has had authority to make credit investigations and special examinations. Although he has subjected some member state banks to this authority, the conditions surrounding one of the largest American bank failures ⁴⁹ in history in New York City indicate that there was much to be desired in protecting depositors through the examination function.

⁴⁹ See chapter V, pp. 101-102.

CHAPTER XV

CENTRALIZATION OF FOREIGN POLICY OF THE RESERVE SYSTEM

Scope of Foreign Relations under the Federal Reserve Act

Authority for American contact with foreign financial institutions was prescribed in the Federal Reserve Act. The original Act empowered every Federal Reserve bank to carry on certain transactions with banks in foreign countries or to engage in business itself abroad by means of its own agencies or branches.¹ The Act is specific as to what kind of business the Reserve banks may do and authorizes three modes of carrying on such business. They are:

1. Maintain banking accounts in foreign countries.
2. Appoint correspondents in foreign countries.
3. Establish agencies² in foreign countries.

The Act also states that such foreign relationships may be undertaken only "with the consent of the Federal Reserve Board." Early in the history of the Federal Reserve system the question of establishing branches of the Reserve banks abroad was discussed. The Board decided, in 1916, not to establish any such branches for several reasons, largely involving the opposition of the larger banks doing a foreign trade financing business.³ No such agencies have been established other than a minor one of quite limited scope operated jointly by the Federal Reserve Banks of Boston and Atlanta in Havana, Cuba, opened in 1923.⁴ The policy of the Federal Reserve has been distinctly ad-

¹ Section 14.

² The term "agency" means an office of a Reserve bank or banks. It may be thought of ordinarily as a branch. But in section 14 it is technically differentiated from the term "branch" as used in section 25 of the Federal Reserve Act in reference to branches of national banks. Willis, *The Federal Reserve System*, p. 1234.

³ See Willis, *op. cit.*, chapter LIV.

⁴ See Annual Report of the Federal Reserve Board, 1923, p. 45.

verse to extending its operations by opening branch agencies in the foreign field. This has left foreign contacts to be made in the other two ways, opening accounts and appointing correspondents. By an amendment approved September 7, 1916, authority was given for a Federal Reserve bank, with the consent of the Federal Reserve Board, to open and maintain banking accounts *for* foreign correspondents or agencies.

Centralization of Foreign Relations in the New York Reserve Bank

During the latter part of 1916 the relations of the United States Government with European governments became quite delicate. It was considered desirable in government circles in view of the war and the probability of our own participation in it to be prepared for eventualities. Accordingly the Federal Reserve Board was solicitous about the inauguration of correspondent relations between the Reserve system and the Bank of England. For reasons which have never been made public, the Federal Reserve Board chose not to carry on the correspondence relative to this central banking relationship but directed the New York Reserve Bank to conduct the negotiations with the Bank of England.⁵

Following an announcement that a large issue of British Treasury bills was about to be offered in this country, the Federal Reserve Board made a lengthy pronouncement warning American banks against becoming non-liquid by buying foreign war securities.⁶ This was taken in some quarters to mean that Washington had "broken" with Britain. President Wilson was desirous of maintaining a neutral position and an announcement of the new agency relationship with the Bank of England was therefore quickly made by the chairman of the Federal Reserve Board, Secretary McAdoo, with a view, for one thing, of offsetting any unwarranted effects of the British Treasury bill episode.⁷ In its

⁵ Willis, *The Federal Reserve System*, p. 1100.

⁶ Federal Reserve Bulletin, Dec. 1, 1916, p. 661.

⁷ Willis, *op. cit.*, p. 1101.

Federal Reserve Bulletin for January 1, 1917, the Federal Reserve Board stated:⁸

The Board has had under consideration for some time the advisability of authorizing the Federal Reserve banks to establish one or more correspondents or agencies in Europe and under date of December 20, 1916, passed a resolution approving the application of the Federal Reserve Bank of New York for authority to establish an agency with the Bank of England.

The United States, having declared war on the central powers on April 6, 1917, our central banking system found itself in a position to quickly bring to a head the international banking relationships. The first such relationship was concluded May 3, 1917 between the Federal Reserve Bank of New York and the Bank of England. It was formal in character and was reduced to a written agreement, ratified by the directors of the two banks, which covered in detail the nature of their operations and made "a close, effective and complete agency." The written agreement provided that the Bank of England would act as correspondent and agent in England of the Federal Reserve Bank of New York and the Reserve Bank of New York would act as correspondent and agent in America of the Bank of England.⁹

The understanding at the time was that the New York Reserve Bank would act on behalf of the other Reserve banks and that whatever services were needed by them would be handled by and through the Federal Reserve Bank of New York. The Federal Reserve Board had announced that other Reserve banks might participate in the agency relationship that would govern the New York Reserve Bank.¹⁰ Unequivocal authority for such relationship was later contained in the so-called war amendments to the Federal Reserve Act of June 21, 1917.¹¹ Pursuant to the reciprocal arrangements entered into with the Bank of England, the New York Reserve Bank, in June, 1917, paid for the account of some English banks a loan of \$52,500,000

⁸ Federal Reserve Bulletin, Jan. 1, 1917, p. 4.

⁹ Annual Report of the Federal Reserve Bank of New York, 1917, p. 29.

¹⁰ Federal Reserve Bulletin, Jan. 1, 1917, p. 5.

¹¹ Public Act, No. 25, 65th Congress, section 6.

with interest, maturing in New York; and received in return gold sovereigns of equivalent value from the Bank of England and held in the Bank of England earmarked for the account of the Federal Reserve Bank of New York. This transaction marked the beginning of the relationships of the Federal Reserve system with central banks abroad.

The other Federal Reserve banks were allotted "shares" in the transaction to the amount of about \$34,000,000,¹² but they held no gold in London. The Bank of England held the gold to the credit of the New York Reserve Bank and the latter held balances to the credit of the other Federal Reserve banks. Various types of transactions between the New York Reserve Bank and central banks, throughout the history of the Federal Reserve system, have given rise to central bank balances where the New York Reserve Bank has acted as the agent of the other Federal Reserve banks. But the principle of the New York Bank's acting as the agent for all Reserve banks and allotting them participation in its foreign business finds its first application in this war-time transaction with the Bank of England.

In this case it will be noted that the Federal Reserve Board authorized the relationship in advance, while the negotiations were carried on by the governor of the New York Reserve Bank and the details of the written agreement were ratified by the boards of directors of the two banks concerned.¹³ Following this transaction most of the foreign loans of the Federal Reserve system have been arranged by the New York Reserve Bank and then subsequently were made known to the Federal Reserve Board,¹⁴ while so far as the other Reserve banks are concerned they "were informed that they would be expected to contribute in proportion to their assets."¹⁵

Banker for the Government in Foreign Transactions

The early foreign relations of the Federal Reserve Bank of New York involved transactions growing out of the war

¹² Annual Report of the Federal Reserve Bank of New York, 1917, p. 29.

¹³ Annual Report of the Federal Reserve Bank of New York, 1918, p. 29.

¹⁴ Congressional Record (unbound edition), Feb. 10, 1930, p. 3.

¹⁵ *Idem*.

and some of these were closely linked with the United States Government for which that Bank served as banker. The Bank accepted in return for its payment of a loan maturing in New York, in June, 1917, sovereigns of equivalent value earmarked in the Bank of England. Part of this gold was turned over to the Treasury department for the use of the United States Government or its allies in Europe.¹⁶ To secure payment for wheat and other commodities sold to Europe in 1918, the Treasury department requested the Bank to open an account with the Netherlands Bank. Payment for these exports was effected by crediting the account of the New York Reserve Bank in guilders¹⁷ and the proceeds were used to effect disbursements for the War department. The Sveriges Riksbank of Stockholm and the Norges Bank of Christiania also opened accounts in favor of the New York Reserve Bank in 1918 for similar purposes.¹⁸

During the war the foreign exchanges between the United States and South American countries were demoralized. Pursuant to an arrangement between the United States and Argentine governments, the Federal Reserve Bank of New York and the Banco de la Nacion appointed each other correspondents. The New York Bank "undertook to receive deposits not exceeding \$100,000,000 exportable in gold coin after the proclamation of peace and the deposit of over \$16,000,000 of gold coin" earmarked in New York.¹⁹ The purpose of the arrangement, the stabilization of exchange between the countries involved, was fulfilled. The United States made analogous agreements with the governments of Bolivia and Peru as a result of which the New York Reserve Bank served as banker to the Government in ways similar to that in which it served with Argentina.²⁰

The foreign exchange relations between the United States and India were also demoralized. A comprehensive arrangement was made between the United States and the British Government whereby the latter supplied the New York Reserve Bank with sufficient rupee exchange each month

¹⁶ Annual Report of the Federal Reserve Bank of New York, 1918, p. 29.

¹⁷ *Idem.*

¹⁸ *Ibid.*, p. 30.

¹⁹ *Idem.*

²⁰ *Idem.*; 1919, p. 32.

to enable importers in America to pay for goods from India.²¹ Operations under the arrangement were from November, 1917 to May, 1919. In this period the New York Bank received a total credit of over 200 million rupees and sold all of it to our importers, resulting in a satisfactory stabilization of exchange rates on India.²²

Another service rendered the Government by the New York Reserve Bank involved several central banking features—acquiring gold abroad, earmarking and increasing our gold reserves, and acting as agent for the other Reserve banks. The German Government in 1919 purchased food-stuffs in the United States from the United States Grain Corporation and paid for them in gold amounting approximately to 730,000,000 marks. The marks were deposited in the National Bank of Belgium, Brussels, and the Netherlands Bank, Amsterdam. The United States Grain Corporation secured payment for the sales at the bullion value of the marks from the New York Reserve Bank and the latter took claim to the gold marks. At the request of the New York Reserve Bank, the Bank of England transferred the gold marks from the continent to London where they were assayed and converted into bars. The gold was earmarked by the English bank for the account of the Federal Reserve Bank of New York which added it to its gold reserves. The New York Bank acted as agent of the other Reserve banks and prorated the gold among them, thus increasing the reserves of all the regional banks.²³

Still another type of foreign transaction for the Government was with the Bank of Spain. The Treasury department had issued certificates of indebtedness in connection with a large Spanish peseta credit. The New York Reserve Bank opened an account in 1919 with the Bank of Spain to receive therein the pesetas which it purchased as fiscal agent of the United States to retire the peseta certificates of indebtedness.²⁴

²¹ Annual Report of the Federal Reserve Bank of New York, 1919, p. 32.

²² *Ibid.*

²³ *Ibid.*, pp. 33-34; 1920, p. 48.

²⁴ Annual Report of the Federal Reserve Bank of New York, 1919, p. 32.

The New York Reserve Bank also facilitated the work of the Reparation Commission. This work assumed such large proportions that during 1921 and 1922 the Bank's transactions with the Bank of England, the Bank of France, and the Bank of Belgium, related principally to reparations payments handled on behalf of the Reparation Commission.²⁵

During the war and early post-war years the transactions of the Federal Reserve Bank of New York with foreign central banks were generally such as grew out of the war conditions. They concerned the stabilization of rates of exchange, gold transfers, government finance, and reparations. In this period the Bank laid the basis for its world-wide network of foreign banking connections and its position as representative of the Federal Reserve system abroad. It established banking contacts with the central banks or banks of issue of fourteen countries²⁶ and the Government of the United Kingdom.

International Financial Relations

Prior to the World War the American banking system had relatively few contacts with foreign banking systems. Such direct relations as existed were those of a few of the largest banks which had branches or accounts with correspondents abroad, the function of which was the financing of foreign trade. Although several of the leading commercial nations had central banks, they dealt very little with each other, while American banks had practically no relations with them. Nevertheless, the world-wide ramifications of American trade and finance had become quite entangled with those of other nations. In reality, therefore, the United States had become a member of an economic organization of nations which carried on international trade for many years based on the gold standard. This organization was a partnership of nations and though not

²⁵ Annual Report of the Federal Reserve Bank of New York, 1921, p. 33; 1922, p. 34.

²⁶ They were the banks of: England, Italy, France, Japan, Philippines, Netherlands, Sweden, Norway, Argentina, Bolivia, Peru, Java, Spain, and Belgium.

formally organized as such, still was bound together not only by an infinite variety of customs and conventions of long standing, but by a network of legal contracts. It has indeed been a sort of financial "League of Nations."

The war interrupted normal foreign financial relations but it did not destroy the operation of the international network of finance. International financial relationships increased during and following the war. The monetary and banking systems of nations were interdependent to a greater extent than ever before. To the pre-war entanglements had been added problems of currency inflation, monetary standards, foreign exchange, war claims, internal and external indebtedness, and heightened tariff barriers. The decade of the '20s opened with the European countries off the gold standard. All of these things vitally involved the nations concerned and particularly their banking systems.

European statesmen devoted their attention to these problems of reconstruction. In an effort to solve their common problems the European powers held a conference at Genoa, Italy, in April, 1922.²⁷ Particular attention was given to the problem of achieving stability of their money and credit systems. The conference resolved that the essential requisite for the economic reconstruction of Europe was the achievement by each country of stability in the value of its currency, and advocated the restoration of the gold standard. Furthermore, it advocated the establishment of a central bank in every country where none existed. In due course a number were established and the central banks of the various countries were made the fountain head of rehabilitation and the means for connecting the money and credit mechanism of each country with such mechanisms of the others.

In this financial "League of Nations" one nation cannot take any major action concerning its standard of value, prices, credit policy, or trade, without affecting the others in the "league." The problem of money, or the regulation of its value, transcends the boundaries of national sov-

²⁷ See Report of the Genoa Financial Commission, Federal Reserve Bulletin, June, 1922, p. 67.

ereignty. The control of credit within any one country is an international problem. That money markets in the leading commercial countries have been closely connected with each other is evidenced by the movement of interest rates in these markets. As C. H. Kisch has pointed out, the rates in leading money markets have, especially since the World War, tended to move together.²⁸ Each nation has, therefore, an interest in what the others do in these lines. However, in this country before the war, there was no bank or institution which could present a unified financial policy in international affairs representative of the entire nation. Fortunately, the passage of the Federal Reserve Act provided for a central banking organization in time to render service during the critical war period and laid the basis for presenting a national front abroad. This service, as we have seen, was rendered by the New York Reserve Bank.

International Conferences of Central Bank Officials

An outstanding development in international relations in the '20s was the conferences of officials of central banks. The American "representative" in these conferences, unauthorized by the Federal Reserve Board, was the governor of the Federal Reserve Bank of New York. The governors of the New York Bank and the Bank of England got together first. Beginning in 1920, Montagu Norman, governor of the Bank of England, made annual trips to America to confer with the governor of the New York Reserve Bank. Likewise that Reserve Bank official has made periodical trips abroad for such conferences, sometimes twice a year. There was made available to him a desk and a private secretary in the Bank of England.²⁹ Gradually as the scope of

²⁸ C. H. Kisch, "The Part Played by Central Banks in International Affairs," *The Royal Institute of International Affairs Journal*, May, 1930, p. 368. Mr. Kisch cited for example, changes in the rates of different central banks in 1929. Tracing them, he found that between January 1, 1929, and October 31, 1929, there were 21 changes upward against 2 reductions. Between November 2, 1929, and December 31, 1929, there were 17 changes, all of which were downward. Says Mr. Kisch: "The succession of a period of an upward drive by a period of general descent exemplifies the international link of which I have been speaking."

²⁹ Congressional Record (unbound edition), Feb. 10, 1930, p. 3526.

their conferences widened they commonly included the heads of the Bank of France and the Reichsbank.

Notwithstanding that these conferences assumed great significance in the eyes of the financial community, they were shrouded in secrecy. It might have been presumed, under the existing conditions, that the central bank heads would discuss such fundamental issues as gold reserves and the restoration of monetary standards. However, they characteristically remained silent as to the real purpose of their meetings. Not only was the public not informed as to the nature of the conferences, but their proceedings were not even reported to the Federal Reserve Board.

The central bank heads stoutly maintained that in these conferences they were concerned with no topics of importance or of general interest. Their foreign trips were described as being for the purpose of "taking a vacation," "visiting with friends," and to "see my pals." "Courtesy visits," "courtesy greetings," "visits with old friends" were other phrases they employed to describe these collaborations abroad. In 1926, Governor Strong of the New York Reserve Bank and Governor Norman of the Bank of England were in France and held conferences with Governor Moreau of the Bank of France. An Associated Press dispatch from Nice, France, stated: "Mr. Strong and Mr. Norman are spending hours daily together, although the American banker asserts they are studying rural life, not finance."³⁰

As an example of the way in which the New York Reserve Bank, rather than the Federal Reserve Board, carried on foreign negotiations for the Federal Reserve system the following dispatch from Paris to the New York Times under date of November 11, 1930, may be cited:

European banking circles are looking forward to the visit of George L. Harrison, governor of the Federal Reserve Bank of New York, who reached England tonight aboard the Mauretania, if for no other reason than for the opportunity it will afford for obtaining authoritative American opinion regarding the position

³⁰ Journal of Commerce [New York], July 21, 1926.

of Washington in the event that reconsideration of Germany's war obligations becomes necessary.

Mr. Harrison has come to Europe to confer with heads of the State Banks of Great Britain, France, and Germany, and in some well-informed quarters his journey has been associated with new arrangements for war debts and reparations as a preliminary to an international trade revival.³¹

On the occasion of this trip to Europe, in November, 1930, the governor of the New York Bank reported his mission as involving only matters of "pure routine" and as "a regular business trip," giving no indication as to the subject matter of his conference abroad.³² Foreign officials, however, were more informative than the Reserve Bank governor and indicated that the central bank conferences involved not routine matters but issues of vast importance to the American people. Their statements purported to show that the New York Federal Reserve official was discussing with them matters involving the lending of the resources of the Federal Reserve system abroad and the sending to Europe of the ultimate gold reserves of the American banking system. Thus said André Tardieu, Premier of France, before the American Club in Paris:

Our two countries are in a position to take together the leadership in a great movement for the betterment of world conditions; for reconstruction and peace. We have that responsibility, being the world's two biggest gold holders, and we share that duty.

We can do something separately. We can do infinitely more together and in association with others.

Recently I had the pleasure of conferring with George L. Harrison, governor of the Federal Reserve Bank of New York, on means of action, and in the coming months you who do business here between our two countries and with the rest of the world may see us working in accord together along what we believe to be the right road toward a new and better prosperity.³³

And a high official of the Bank of France said that as a result of Governor Harrison's visit, relations between the Bank of France and the Federal Reserve Bank of New York had become very close and that the arrangements they had

³¹ The New York Times, Nov. 12, 1930.

³² The New York Times, Nov. 13, 1930; Dec. 3, 1930.

³³ The New York Times, Nov. 28, 1930.

consummated concerned the conditions under which loans would be made and where.³⁴

In the summer of 1931, Governor Norman left England "quite unexpectedly for Quebec, ostensibly for his health." While there the governor of the New York Reserve Bank journeyed to Quebec and conferred with the English banker. Shortly after Governor Norman's return home, Britain went off the gold standard.³⁵ Greater secrecy even than usual surrounded the conference of the governors of the Bank of England and the Federal Reserve Bank of New York in August, 1932. On this occasion Governor Norman landed at Boston. He traveled under the name of "Professor Clarence Skinner" and the ship's personnel was instructed not to reveal the banker's identity.³⁶ On his trip to New York, aside from a visit to Governor Harrison's office in the New York Reserve Bank, Governor Norman spent nearly all of his time in the residential apartment of Governor Harrison.³⁷ After returning to London, the general court of the Bank of England moved a "vote of thanks" to Governor Norman. At this meeting of the general court a stockholder of the Bank of England is reported to have said: "His recent trip to the United States *sowed a seed* which, in the future, will bear fruit, not only for Britain, but also for the rest of the world."³⁸ And yet on the occasion of this trip he was reported to have come to the United States only for a "vacation jaunt." It should be noted also that his only contact with the Federal Reserve system was with the governor of the New York Reserve Bank and not the Federal Reserve Board.

The International Conference of 1927

Perhaps the most noteworthy occasion of the extent to which the foreign relations of the Federal Reserve system have been in the hands of the New York Reserve Bank and the secrecy of such operations is furnished by the summer

³⁴ The New York Times, Dec. 3, 1930.

³⁵ The New York Times, Aug. 21, 1932.

³⁶ *Idem*.

³⁷ The New York Times, Aug. 30, 1932.

³⁸ The New York Times, Sept. 24, 1932.

conference of foreign central bank heads with the governor of the New York Bank in 1927. This conference was composed of representatives of the Bank of England, the Reichsbank, the Bank of France, and the Federal Reserve Bank of New York. It was the first one at which representatives of all these central banks were brought together. The members of this conference practically agreed upon a general reduction in discount rates and that the Federal Reserve rates were to be lower than those of the foreign central banks.³⁹

Following the conference this plan was put into effect as a result of which almost \$600,000,000 of gold was exported by mid-summer of 1928, the largest international gold movement in peace-time history. The purpose of the easy money policy was to help Europe, especially Great Britain, but that this way was taken to do it was probably influenced by the desire of a group who wanted Federal Reserve credit at low cost which would enable them to make profits in securities speculation.⁴⁰ In this international arrangement involving the Federal Reserve system, the Federal Reserve Board was not a party.

It was the governor of the New York Reserve Bank who undertook to confer with the foreign central bank heads, to speak for the Federal Reserve system, and to commit the banking resources of America to their service. The Federal Reserve Board met the foreign central bank officials only socially and then through the courtesy of the governor of the New York Bank.⁴¹ This meeting was at a luncheon given by the governor of the Federal Reserve Board and the question of discount rates was not discussed.⁴² On the other hand vital and far-reaching foreign relations of the Federal Reserve system including relative discount rates were discussed at the central banking conference, the meet-

³⁹ Stabilization Hearings on H. R. 11806, 1928, pp. 217, 318.

⁴⁰ H. Parker Willis, "The Discount Rate Controversy in the United States," *The Banker*, London, November, 1927, pp. 408-416; H. Parker Willis, "The Failure of the Federal Reserve," *North American Review*, May, 1929, pp. 547-556.

⁴¹ Stabilization Hearings on H. R. 11806, 1928, pp. 217, 405.

⁴² *Idem*.

ings of which were held at the Federal Reserve Bank of New York and the Long Island estates of Ogden Mills and Mrs. Ruth Pratt.⁴³

It was Governor Strong of the New York Bank who issued a formal statement at the time regarding this international conference of central bank officials. The scope of the foreign affairs discussed by them as well as the non-relation of the Federal Reserve Board thereto may be seen from his statement which, in part, was as follows:

During the past week their time has been devoted mainly to exchange of views regarding financial and economic matters, the policies of the banks of issue and like subjects which are of concern to these institutions. These subjects naturally include the relationship of their respective rates of discount, the question of the so-called gold exchange standard, which has had so extensive a development since the war; the expensive shipments of gold, which necessarily affect the reserves of the banks of issue; the purchasing power of gold, and various proposals to promote closer coöperation.

Yesterday was spent in Washington in order to make calls of courtesy upon members of the Federal Reserve Board and to attend a luncheon given by the Board, at which the officers of the Treasury department were present.⁴⁴

Power of the New York Reserve Bank Abroad: Foreign Recognition

Consequent upon the 1927 international central bankers' conference and the adoption of the easy money policy on the part of the New York Bank, a similar policy was initiated at several other Reserve banks. The Chicago Reserve Bank was among those Reserve banks which refused. Whereupon, following pressure from the New York Reserve Bank or its governor, a low discount rate was forced on the Chicago Bank by the Federal Reserve Board. As a consequence there was considerable controversy throughout the country about the management of the rate policy. Chicago bankers frequently voiced their convictions to the effect that the Federal Reserve discount rates were being practically

⁴³ Current History, October, 1932, p. 27.

⁴⁴ The New York Times, July 9, 1927.

dictated by the Bank of England.⁴⁵ And Governor Norris of the Federal Reserve Bank of Philadelphia stated in public substantially that it had been necessary to lower rates in America in order to avoid hurting business in Great Britain and some other European countries.

The Chicago Tribune called for the resignation of Governor Strong of the New York Bank. It based its demand upon the ground that he had been attempting to control discount rates in the interest of Great Britain. Apropos to this matter the British thought very highly of Governor Strong and appreciated what he did for them. Thus, for example, one of their leading financial journals, *The Banker*, said editorially:

London has recently been honored with the presence of Mr. Benjamin Strong, governor of the Federal Reserve Bank of New York. The United States contains no better friend of England than this great banker. While mindful of the proper interests of his own country, he has been a generous friend of England, and we owe much to the energy and skillfulness he has given to the service of England. This work is not well known to the public, but those who have had the opportunity of appreciating his efforts will not contradict the assertion that his name should be associated with that of Mr. Page as a friend of England in her greatest need.⁴⁶

Writing in 1927, Hon. Philip Snowden said:

When Mr. Norman was elected governor he effected a great but unseen revolution. He gave his whole time to the governorship, he established relations with the heads of the central banks of the world—particularly with the Federal Reserve Bank of New York; and he gradually evolved a policy of coöperation between the central banks of the world for the reconstruction of Europe. . . . The magnificent support given to Great Britain by the Federal Reserve Bank of New York owes much to the great friendship between Mr. Norman and Mr. Strong. In these days of immense impersonal business the comradeship of two great bankers in the beneficent work of international reconstruction is indeed remarkable.

In using, as he has done, the great opportunities which his position as governor of the Bank has provided to promote inter-

⁴⁵ See also chapter VIII, p. 171.

⁴⁶ *The Banker*, London, June 1, 1926, p. 403.

national goodwill, Mr. Norman has set an example to all who are engaged in commerce and finance, of how chivalry and comradeship may be combined with business management. ⁴⁷

Following the effects of the collaboration of Governor Norman of the Bank of England with the governor of the Federal Reserve Bank in New York, *The Banker*, in its issue of November, 1928, complimented Mr. Strong as being "one of the best friends England ever had" and said that he had "served Europe much better than those who owe both their birth and fortune to it." ⁴⁸

Similar recognition of the authority and power of the New York Reserve Bank in foreign affairs in place of the Federal Reserve Board has been expressed also in Germany and France. As examples of such the following may be quoted:

Mr. Benjamin Strong, governor of the Federal Reserve Bank of New York and the leading head of the American bank of issue system, did not allow prices to sink further but caused them to rise somewhat. In other words, he has made gold—the whole world's currency basis, which is managed by the United States, cheaper and not dearer. ⁴⁹

The Bank of France rendered a public homage to American collaboration in a communication in 1928. "The gold which the Bank has bought since August, 1926, whether in public in the form of moneys, or whether in ingots in foreign markets, and particularly in the American market, is a finished operation, thanks to the facilities it has met, notably in the Federal Reserve Bank of New York, whose friendly collaboration deserves to be underlined." ⁵⁰

It has been the officials of the New York Reserve Bank who have represented the Federal Reserve system in its foreign relations. As a result of these international central bankers' conferences, there have evolved "agreements on discount rates, international credits among central banks, and secret understandings of one sort or another."

⁴⁷ The Right Hon. Philip Snowden, M. P., "The Bank of England and European Reconstruction," *The Banker*, London, May, 1927, pp. 376-381.

⁴⁸ *The Banker*, London, November, 1928, p. 141.

⁴⁹ *Frankfurter Zeitung*, Dec. 25, 1927.

⁵⁰ *Revue Des Deux Mondes*, February, 1929.

Establishing Foreign Monetary Systems

Perhaps the most important use of the New York Reserve Bank's power was the agreements it made with central banks to enable them to restore the gold standard in their respective countries.⁵¹ The forerunner of all these and by far the outstanding one was that with the Bank of England in 1925.⁵² According to this arrangement the New York Bank undertook to sell gold on credit to the Bank of England from time to time during the following two years, but not to exceed \$200,000,000 at any one time.⁵³ In other words the New York Bank contracted to furnish the Bank of England gold up to a total value at any one time of \$200,000,000. The Bank of England could then ship the gold out of the United States, earmark it in the Reserve Bank's vault, or use it to make payments in this country. The gold was to be paid for by deposit credit on the books of the Bank of England. The purpose of the agreement was to stabilize sterling exchange by enabling the Bank of England to meet a foreign demand for gold without reducing its own reserves, or enabling it to replenish its reserves by drawing gold from the Reserve Bank or earmarking it at the Reserve Bank.

The contract was negotiated by Governor Strong of the New York Bank and Governor Norman of the Bank of England.⁵⁴ The New York Bank made arrangements with all the other Reserve banks whereby the latter shared pro rata in this contingent liability transaction.⁵⁵ The liability of the

⁵¹ Of the many countries which went off the gold standard during the war, the United States was the first to return to it. The American Government removed gold export restrictions in 1919.

⁵² Concerning the restoration of the gold standard in Great Britain in 1925, see Federal Reserve Bulletin, June, 1925, pp. 369-373. Britain's return to gold in 1925 meant not the free coinage of gold or the issuance of a certain amount of paper currency on a certain gold reserve, but that its international trade went on a gold standard basis. It remained on this basis until September, 1931, when it suspended gold payments on foreign trade balances. Britain's monetary standard from 1925 to 1931 may be designated the "gold bullion standard."

⁵³ Federal Reserve Bulletin, June, 1925, pp. 371-373; Annual Report of the Federal Reserve Bank of New York, 1925, pp. 9-11; Annual Report of the Federal Reserve Board, 1925, pp. 10-14.

⁵⁴ Stabilization Hearings on H. R. 7895, 1926, p. 512.

⁵⁵ *Ibid.*, p. 497.

other Reserve banks ran to the New York Reserve Bank and not to the Bank of England.⁵⁶ In connection with the contract between the New York Bank and the English bank, J. P. Morgan and Company made a contract with the British Government whereby the banking house would loan the latter \$100,000,000 of gold if desired. Should the credit have been used, the gold which Morgan and Company agreed to supply the British Government would have had to come from the gold reserves of the Federal Reserve system just the same as in the case of the Reserve Bank's obligation to the Bank of England.⁵⁷ In case Great Britain needed the gold it was understood that the officials of the Reserve Bank and the Morgan Company would collaborate and decide which credit would be drawn upon.⁵⁸ The Bank of England did not buy any gold under this contract or use any part of the credit so promised.⁵⁹ Likewise none of the Morgan credit was used.

The New York Reserve Bank effected loan agreements along similar lines with other central banks in order to stabilize their currencies in relation to gold. While some loans secured by gold were made by the Bank, the loan contracts usually took the form of agreements to purchase prime commercial bills up to a maximum amount from the central banks if they desired to sell them. The central banks which the New York Reserve Bank aided to stabilize their

⁵⁶ *Ibid.*, pp. 269, 270.

⁵⁷ *Ibid.*, p. 512.

⁵⁸ *Ibid.*, p. 497.

⁵⁹ There was a great deal of criticism against this arrangement between the New York Reserve Bank and the Bank of England in the United States at the time. Its legality was seriously questioned. Among others considerable concern was felt by the members of the Federal Reserve Board and the officers of the other eleven Federal Reserve banks. (See Congressional Record [unbound edition], Feb. 10, 1930, p. 3525.) The criticisms of the agreement were to the effect that (1) it was a binding prearrangement which left the initiative with the Bank of England but did not permit of the freedom of action as to time and amount contemplated by the Federal Reserve Act, and (2) it authorized revolving credits the final maturity of which was longer than was permitted for eligible paper. The arrangement was investigated by the House Committee on Banking and Currency and was then defended by Governor Strong of the Reserve Bank. (See Stabilization Hearings on H. R. 7895, 1926, pp. 494-512.)

currencies and the extent of the Bank's liability thereunder were: ⁶⁰

Bank of England (1925)	\$200,000,000
National Bank of Belgium (1926)	10,000,000
Bank of Poland (1927)	5,250,000
Bank of Italy (1927)	15,000,000
National Bank of Roumania (1929)	4,500,000

Although the central banks in Great Britain, Belgium, and Roumania did not use any of the credits guaranteed, the fact that financial assistance of the central banking system of the United States was contracted for and was available should the need arise undoubtedly was an element of considerable support in enabling those countries to achieve stabilization and obviating such a need.

Besides these guaranteed credits and loans the Reserve Bank coöperated with foreign central banks to aid them in restoring the gold standard through its discount and open market policies. In 1924 and 1927 the Bank lowered discount and open market rates and made extensive open market purchases. Its easy money policy in these periods tended to result in the sale of foreign securities in this country and exchange rates favorable to foreign countries. The checking of gold imports and the increasing of gold exports were desired and these results ensued at the time.⁶¹ The support of foreign efforts to return to gold was stated to be a vital factor in motivating the New York Bank's easy money policy in both of these periods.⁶² While the work of reorganizing the foreign disarranged monetary systems was materially aided by the resources of our central banking system, the impetus of American participation was supplied by the New York Reserve Bank.

⁶⁰ Annual Reports of the Federal Reserve Bank of New York, 1925-1929.

⁶¹ The United States was overwhelmingly a creditor nation. While the efforts of the Reserve Bank to redistribute the gold stock held in the United States did succeed to some extent immediately, they were in the long run largely ineffective in the face of the forces determining gold movements. The long time result was net imports into the United States.

⁶² Hearings on Banking Systems, 1931, pp. 762-763, 816-817.

Supporting the Gold Exchange Standard

The New York Reserve Bank did not enable foreign countries to return to a gold standard of the kind that was practiced before the war, that is, one where there were no restrictions on gold exports or imports, convertibility of all kinds of money and of bank credit into gold, and no opposition to hand-to-hand circulation. But it did enable them to establish a variant of the gold standard—the gold exchange standard. Under this standard central banks invested a considerable part of their resources in liquid foreign assets. These foreign assets constituted a part of their operating reserves and in many cases were counted as part of their legal reserves.⁶³ Such assets consisted of deposit balances, bills of exchange on foreign countries, foreign bank notes, short-term investments in foreign markets—including acceptances, treasury bills, and loans on stock exchange collateral.

Of the total holdings of foreign assets by central banks, there was reason to believe that the proportion held in the United States was large.⁶⁴ Countries set their monetary units at a certain relationship to the dollar and endeavored to keep them there through the operation of the foreign exchange mechanism. This involved the accumulation of dollar balances which the statutes of many European and South American countries permitted their central banks to count as a part of their legal reserves.⁶⁵ Foreign balances were accumulated in America and served this purpose.⁶⁶ They were subject to conversion into gold on demand. This conversion was followed by actual withdrawal for export or earmarking. In either case the gold reserves of the Reserve system were depleted. Concerning this subject the Federal Reserve Board had the following to say: ⁶⁷

⁶³ Federal Reserve Bulletin, June, 1927, p. 392.

⁶⁴ There was no way to determine this proportion closely, but the Federal Reserve Board, in 1927, held that perhaps as much as \$1,000,000,000 of the operating reserves of foreign central banks was in dollar exchange. Federal Reserve Bulletin, June, 1927, p. 392.

⁶⁵ Federal Reserve Bulletin, April, 1925, p. 234. For a summary of the legal reserve requirements of many central banks, see Federal Reserve Bulletin, June, 1927, p. 394.

⁶⁶ Stabilization Hearings on H. R. 7895, 1926, p. 452.

⁶⁷ Federal Reserve Bulletin, June, 1927, pp. 392-393.

In view of the strong reserve position of the Federal Reserve banks and of the American policy of placing no legal or practical restrictions on gold withdrawals, so that balances with banks in the United States are convertible at any time into exportable gold, dollar exchange is considered throughout the world as equivalent to gold. To build up the volume of dollar exchange at their command has been the policy of many central banks, which find it safe, convenient, and profitable to keep a portion of their reserves productively employed in the United States, rather than to keep them unproductive in the form of gold in vault.

The gold reserves of our central banking system, therefore, served as the base not only for our own money and credit in use but for the monetary systems of foreign countries as well.⁶⁸

In the operation of the gold exchange standard, although the gold reserves of all the Reserve banks were subject to such use, it was the New York Bank which felt the immediate responsibility. The actual policies and processes by which the gold exchange standard was supported were executed by that Bank. The Bank administered foreign balances and invested them pursuant to instructions from abroad. It met the demands for gold on the part of foreign interests whether for earmarking or exporting. The New York Bank, therefore, had the important duty of adjusting its policies with reference not only to the domestic situation, but to foreign conditions, the policies of foreign central banks, the large volume of short-term balances located here and their withdrawal in gold.⁶⁹ Thus in supporting the gold exchange standard as well as in other international transactions, the foreign policy of the Federal Reserve system was practically centralized in the New York Reserve Bank.

⁶⁸ The gold exchange standard did not last long. Since 1929 European nations have been returning not to gold but to a paper basis. Monetary relationships in Europe have again become disarranged. Concerning the gold exchange standard and its failure, see Federal Reserve Bulletin, June, 1927, pp. 391-394; Willis, "The Breakdown of the Gold Exchange Standard and Its Financial Imperialism," *The Annalist*, Oct. 16, 1931, p. 626. See also a discussion of the gold exchange standard by Feliks Mlynarski in his book, *Gold and Central Banks*, chapter V.

⁶⁹ Thus in its Annual Report for 1925, the New York Reserve Bank stated that it was its intention "to exchange information fully" with the Bank of England.

CHAPTER XVI

COLLABORATION WITH FOREIGN CENTRAL BANKS

Establishment of the Bank for International Settlements

The Federal Reserve Bank of New York and its officials were engaged in the post-war foreign relationships growing out of reparations and in the establishment of the Bank for International Settlements. The Reserve Bank maintained an account for the Agent General for reparation payments. A director of the Bank, Owen D. Young, was the man most immediately responsible for the formulation of the so-called Dawes plan, in 1924, for the settlement of reparations. The chairman and Federal Reserve agent of the Bank assisted Mr. Young in Europe in setting up the administration for the Dawes plan. An assistant Federal Reserve agent went to Europe in 1924 and served as economic adviser to the Transfer Committee and later as finance director, Office for Reparation Payments. At the end of 1926, the chairman, Pierre Jay, resigned to go to Berlin to be the American member of the Transfer Committee under the Dawes plan. Finally, his successor, Gates W. McGarrah, held a position in the Reichsbank of Germany as American member of the council while he was chairman of the board and Federal Reserve agent of the Reserve Bank.

The Dawes plan, though it proved useful in some respects, was found to work unsatisfactorily particularly with regard to its transfer provisions. Hence the allied governments reached a decision in Geneva in September, 1928, to set up a committee of independent experts whose duty was to draw up "proposals for a complete and final settlement of the reparation problem." The experts from the respective allied countries were chosen and in addition two from the United States, the latter being appointed by the Reparation Com-

mission conjointly with the German Government. One of the two experts from America was Owen D. Young, who was a director and deputy chairman of the Federal Reserve Bank of New York and the other was J. Pierpont Morgan, the head of J. P. Morgan and Company of New York.¹ The committee of experts held its first regular meeting in Paris, February 11, 1929, and continued in session for seventeen weeks. The deputy chairman of the New York Reserve Bank was chairman of the Experts' Committee. The Reserve Bank was also represented at the Paris conference by its assistant Federal Reserve agent who rendered some technical service.²

During the Committee's deliberations early reports of the preliminary drafts of the new plan had indicated the creation of an International Bank and the inclusion of the Federal Reserve Bank of New York as one of the central banks to set up and run it. Also the press reported that the assistant Federal Reserve agent while in Paris made a flat statement as follows:

The Federal Reserve Bank will act as correspondent to the new establishment as it does for other central banks, which will avoid the necessity of special American legislation. The Federal Reserve Bank will make important deposits of gold in the International Bank abroad and will receive in New York deposits of gold from it.³

As a result of the early reports and this statement, which the official later denied making, the concern felt in many quarters over the foreign activity of the Federal Reserve Bank of New York and the involvement of the Federal Reserve system with the new Bank for International Settlements, the administration in Washington announced its position with regard to the matter. It was stated informally that President Hoover was "opposed to the United States acting through the Federal Reserve system in any manner"

¹ Two alternates were also in attendance—Thomas N. Perkins and T. W. Lamont, the latter being associated with Mr. Morgan as a partner in J. P. Morgan and Company.

² W. Randolph Burgess.

³ The New York Herald Tribune, May 17, 1929; Congressional Record (unbound edition), Feb. 10, 1930, p. 3528.

in setting up the Bank for International Settlements.⁴ The Secretary of State, in response to a Senate inquiry, issued a formal statement of the Government's policy in which he said:

. . . this Government does not desire to have any American official, directly or indirectly, participate in the collection of German reparations through the agency of this bank (Bank for International Settlements) or otherwise . . . it will not permit any officials of the Federal Reserve system either to serve themselves or to select American representatives as members of the proposed International Bank.⁵

This opposition to Federal Reserve participation in the Bank for International Settlements was reaffirmed by the Secretary the next month.⁶

The State department's restrictions upon Federal Reserve participation in the Bank for International Settlements aroused discussion in both houses of Congress concerning the connections of the Federal Reserve with the foreign bank. Senator Glass contended that the Secretary of State was without authority to determine the relation of the Federal Reserve to the new International Bank and the Senate passed a resolution asking for information concerning the activity of the State department in such matters.⁷ Following a reply from the President,⁸ Senator Glass introduced another resolution calling upon the State department to refrain from such intervention in the affairs of the Federal Reserve system,⁹ control over which was expressly vested in its own officers. The resolution was finally passed by the Senate on February 26, 1931.¹⁰

Notwithstanding the traditional attitude of the United States Government against mixing in the collection of reparations, it was expected that approximately two-thirds of the German reparation payments into the International

⁴ The New York Times, May 15, 1929.

⁵ The New York Times, May 17, 1929.

⁶ The New York Times, June 27, 1929.

⁷ Congressional Record, June 16, 1930, p. 11,265. The right of the State department to "sanction" foreign loans was also involved.

⁸ Senate Document 187, 71st Congress, 2nd Session.

⁹ Congressional Record, June 25, 1930, p. 12,076.

¹⁰ Congressional Record, Feb. 26, 1931, p. 6103.

Bank would go indirectly to America in settlement of war debts.¹¹ It was reported that Mr. Young favored representation of the Federal Reserve system in the International Bank.¹² But in accordance with the pronouncement of the United States Government, the report of the Experts' Committee, of which he was chairman, omitted mentioning the Federal Reserve system or any component part of it, save in one place in connection with the "special advisory committee" of the Bank for International Settlements.¹³

New York Reserve Bank Identified as the Central Bank of the United States

The Experts' Report, or as it was generally called, the Young plan, involved as its central factor the formation of the Bank for International Settlements. This bank has two sets of functions. Its primary and obligatory functions are "to receive and disburse reparation payments, effect transfers in certain contingencies, and handle deliveries in kind as long as they are made." The secondary and permissive functions are such as enable it "to act as a bank for other central banks."¹⁴ Although the Young plan did not definitely provide for the association of the Federal Reserve Bank of New York with foreign central banks in the formation of the International Bank, it did provide alternative arrangements which involved the New York Reserve Bank. If the Reserve Bank or its governor could not participate in any of the undertakings, provision was made for representatives of his to serve, whereby, in the words of one of the alternate members of the Experts' Committee, "the same end is intended to be attained."¹⁵

Such alternative provisions were incorporated into the statutes of the Bank for International Settlements concluded at the Hague conference in January, 1930. These statutes set forth the relation of the central banks, of the countries whose nationals were members of the Experts'

¹¹ The New York Times, June 8, 1929.

¹² The New York Times, July 5, 1929.

¹³ Experts' Report, Part VIII(E).

¹⁴ Federal Reserve Bulletin, July, 1929, pp. 461-462.

¹⁵ T. W. Lamont, The New York Times, July 5, 1929.

Committee, to the organization, direction, and operations of the Bank for International Settlements. The Federal Reserve Board is not mentioned in the International Bank's statutes, but the Federal Reserve Bank of New York is clearly indicated in them by defining the term "central bank." They read:

For the purposes of these statutes:—

Central bank means the bank in any country to which has been entrusted the duty of regulating the volume of currency and credit in that country; or, where a banking system has been so entrusted, the bank forming part of such system which is situated and operating in the principal financial market of that country.¹⁶

Since the principal financial market of the United States is in New York, the New York Reserve Bank is identified as the central bank of the United States. The International Bank is empowered to transact business with the central banks of the world and the Federal Reserve Bank of New York and to operate in the New York money market. Furthermore, the Federal Reserve Bank of New York is given in the statutes the power of veto over operations of the International Bank in this financial market. Thus on any questions involving the interests of the United States, the New York Reserve Bank has the power of decision under this plan.

As has been seen, officials of the New York Reserve Bank were vital factors in the formal development in Europe of the plan for the International Bank which had been worked out largely in the Federal Reserve Bank of New York.¹⁷ Officials of the Reserve Bank continued to be prime factors in the establishment and management of the International Bank. The organization committee constituted under the Young plan, to put the bank project into effect, had as its chairman a director of the Reserve Bank.¹⁸ The chairman of the board of directors and Federal Reserve agent of the New York Reserve Bank, Gates W. McGarrah, had been

¹⁶ Article 58, (1).

¹⁷ Hearings before a Subcommittee of the Senate Committee on Banking and Currency on Nomination of Eugene Meyer to be a Member of the Federal Reserve Board, 71st Congress, 3rd Session, 1931, p. 309.

¹⁸ Jackson E. Reynolds, president of the First National Bank of New York.

determined upon as an American director of the International Bank, and, it was generally understood, as its president. He accordingly resigned in February, 1930, to accept an appointment as one of the two American directors of the International Bank and was elected and served as its first president. According to well-known European bankers, an American head for the bank was chosen because of the hope that he would be able "to secure a more friendly attitude on the part of the United States toward reparations and perhaps toward the softening of our debt contracts with the allied governments."¹⁹

Relations with the Bank for International Settlements

The New York Reserve Bank not only participated in the establishment of the International Bank but has operated in close communication with it. That Bank "detailed members of its staff to work in connection with the operations of the International Bank and to keep it advised" of what went on in Basle.²⁰ In the summer of 1931, a seven-power conference of ministers in London arranged that the Bank for International Settlements would set up a committee, nominated by the governors of the central banks interested, to inquire into the financial crisis in Germany.²¹ In consequence, Governor Harrison of the New York Bank nominated Albert H. Wiggin, chairman of the governing board of the Chase National Bank, who represented American interests abroad in the matter of "frozen" German acceptance credits. In accordance with specific provisions in the Experts' Report (the Young plan) when the question of fulfillment of Germany's obligations arose in the fall of 1931, the governor of the New York Reserve Bank was requested by the president of the International Bank to nominate an American member of the Special Advisory Committee provided for in the Young plan. Accordingly, Governor Harrison nominated Mr. Walter W. Stewart, chairman of the board of directors of a New York banking house,²² who

¹⁹ Journal of Commerce [New York], editorial, April 24, 1930.

²⁰ Journal of Commerce [New York], editorial, June 28, 1930.

²¹ The New York Times, July 31, 1931.

²² Case, Pomeroy and Company, Inc.

served in that capacity.²³ It is evident from the above facts that if the requests of the Washington Government can be said to have been observed, they were observed only in the most attenuated and technical sense.

Although established under the auspices of the leading central banks and the Federal Reserve Bank of New York,²⁴ since the policy of the United States Government would not permit the Federal Reserve banks to buy stock of the International Bank, funds from the United States were supplied by a banking group headed by J. P. Morgan and Company, the First National Bank of New York, and the First National Bank of Chicago. These three institutions guaranteed the subscription of one-seventh of the bank's entire capital and subscribed for 16,000 shares, which were subsequently distributed to at least one hundred American banks.²⁵

The investment of the American banks in the stock of the Bank for International Settlements was not based upon our Federal authority. While there is no prohibition in the National Bank Act against the purchase of stock in a foreign bank, national banks have not been authorized by law or by regulation of the Comptroller of the Currency to invest in shares of stock of foreign banks; and the courts have held the purchase of such stock to be *ultra vires* except as specifically authorized by statute. The basis for the affiliation of the American banks with the International Bank is found in the preamble of its charter.²⁶ The control

²³ Annual Report of the Federal Reserve Bank of New York, 1931, p. 24.

²⁴ The Federal Reserve Bank of New York acting unofficially.

²⁵ The Banker, London, November, 1931, pp. 143-146.

²⁶ Agreements Concluded at the Hague Conference, January, 1930: Constituent Charter of the Bank for International Settlements, Preamble: "Whereas the powers signatory to the Hague Agreement of January, 1930, have adopted a Plan which contemplates the founding by the central Banks of Belgium, France, Germany, Great Britain, Italy and Japan and by a financial institution of the United States of America of an International Bank to be called the Bank for International Settlements:

"And whereas the said central banks and a banking group including Messrs. J. P. Morgan and Company, of New York, the First National Bank of New York, New York and the First National Bank of Chicago, Chicago have undertaken to found the said Bank and have guaranteed or arranged for the guarantee of the subscription of its authorized capital amounting to five

of the International Bank is not vested in the shareholders but in the governors of the central banks of the countries involved or their representatives, the latter applying to the New York Reserve Bank. The fact that the three American banks and not the Federal Reserve Bank of New York are affiliated with the foreign central banks in the enterprise does not mean that the Federal Reserve Bank of New York or the Federal Reserve system has not become financially involved in the International Bank.

The three banks comprising the group which guaranteed the subscription for America's allotment of stock in the International Bank would be obliged to obtain the gold to fulfill their contract from the Federal Reserve because they do not carry substantial amounts of gold for such purposes. It is not reasonable to suppose that the officers of the American banks would have undertaken to affix their signatures to the charter if they had not been assured of not only the moral but the financial support of the Federal Reserve Bank of New York. As Lord Melchett of England said in 1929:

It will be impossible to make a success of either the scheme of reparation payments or still more the Bank for International Settlements, unless the financial power of the United States, frankly, fully, and wholeheartedly comes to its assistance.²⁷

Furthermore, J. P. Morgan and Company have been the fiscal agents in this country of foreign governments and have had "close working agreements" with the Federal Reserve Bank of New York.²⁸ Also it will be recalled that of the two American members of the conference in Paris which drew up the plan for the International Bank, one was a director and deputy chairman of the Federal Reserve Bank of New York, who was chairman of the conference, and the other was J. P. Morgan.

Direct correspondent and financial relations between the Federal Reserve Bank of New York and the Bank for International Settlements have been carried on from the time

hundred million Swiss Francs equal to 145,161,290.32 grains, fine gold, divided into 200,000 shares."

²⁷ Congressional Record (unbound edition), Feb. 10, 1930, p. 3528.

²⁸ Ibid., p. 3527.

of the establishment of the latter institution. The Bank for International Settlements opened for business at Basle, Switzerland, in May, 1930, and at this time the New York Reserve Bank opened an account in New York in its favor.²⁹ The relations of the Reserve Bank in New York to the International Bank have been comparable to its relations with foreign central banks. The International Bank's account has been "subject to the same general terms and conditions as the accounts received from foreign central banks of issue."³⁰ The New York Reserve Bank has performed services for it such as investing its funds in bankers' acceptances and short-term United States Government securities, earmarking gold, keeping securities, making collections, paying checks, and transferring funds.

In accordance with the statutes of the Bank for International Settlements, financial operations in the New York money market have been subject to the veto of the New York Reserve Bank in order that the International Bank's operations here may not conflict with the credit policy of the Reserve Bank. In practice this has meant that all of the International Bank's operations in any financial market in the United States have been subject to the authority of the New York Reserve Bank. The reason for this is that the dollar funds the International Bank has employed in the United States have been handled in the first instance through its account with the New York Reserve Bank.³¹ In this way the New York Reserve Bank has been "in a position to understand the nature and volume" of the International Bank's operations in the United States and hence to exercise its veto rights under the International Bank's statutes. The relations between the two banks were considerably enlarged in 1931. In that year the Reserve Bank made deposits in the International Bank. It also extended loans to the International Bank for its (the International Bank's) own account and as intermediary for several central banks.³²

²⁹ Annual Report of the Federal Reserve Bank of New York, 1930, p. 22.

³⁰ *Idem*.

³¹ *Ibid.*, p. 23.

³² Annual Report of the Federal Reserve Bank of New York, 1931, pp. 22-24.

The reports from Paris at the time of the conference of experts in 1929 as to the part the Federal Reserve system, and more particularly the Federal Reserve Bank of New York, was to play in the Bank for International Settlements have been amply confirmed. Subsequent events have shown the extent to which the experts from America and the representatives of the New York Reserve Bank during the conferences, although acting in an "unofficial" capacity, knew whereof they spoke and planned to have the New York Reserve Bank place the reserves of the Federal Reserve system at the disposal of the Bank for International Settlements. Since the opening of the International Bank, the lending of these reserves and the financial relations of the New York Reserve Bank with it have been undertaken under the authority of section 14 of the Federal Reserve Act, the section under which the Bank has been carrying on its relations with central banks. No announcement by governmental authority or the Federal Reserve Board has been made specifying the part the Federal Reserve banks are to play in relation to the International Bank or the use which they might make of the nation's banking reserves for the International Bank and its constituent central banks.

Although the Bank for International Settlements is not a central bank, the New York Reserve Bank has carried on with it financial relations of substantially the same character as it has carried on with foreign central banks.³³ So far as the relation of our central banking system to the Bank for International Settlements is concerned, the Federal Reserve Bank of New York has been the means of contact and actually the institution which has wielded the power. The New York Reserve Bank and its officials, and no other Reserve bank, have been engaged directly in operations with the International Bank. Moreover, policies underlying these operations have been determined by the New York Bank and not by the Federal Reserve Board, the Board acquiescing in whatever was done by the Reserve Bank.

In the discussions attending the formation of the Bank for International Settlements, it was urged that a good

³³ Hearings on Banking Systems, 1931, p. 94.

reason for setting it up was that it would serve as a convenient meeting place for the heads of central banks. They could meet oftener, more regularly and privately, and under more favorable circumstances. It was said that "personal contacts" could be developed which would be valuable aids in the settlement of international problems involving gold, loans, and monetary standards. Such problems not only involve political considerations but monetary and banking policies national in scope. It was over just such affairs that the Federal Reserve Board was given jurisdiction in the Federal Reserve Act. The statutes of the International Bank, however, make no mention of the Federal Reserve Board, but deal with central banks, and by definition, the term "central bank" is made to apply to the Federal Reserve Bank of New York for the United States.

While the settlement of reparations provided the original reason for the establishment of the International Bank, this function very early in its existence became of minor importance. In as short a time as nine months from the opening its president said that the bank's activity in connection with the German reparation payments has become the smaller side of the work, that the latter has become a routine "trust company" operation, and that "nearly the whole thought and energy of the bank are devoted to other financial fields."³⁴ In other words, the functions of the bank in its relations with the central banks of the world became paramount. In carrying out these functions the International Bank provides a recognized common meeting place where the central bank heads may gather and exchange views on monetary and banking policies, stabilization of exchange rates and prices; may reconcile their different points of view and coördinate their policies.

The statutes of the International Bank were prepared so that no legislative sanctions are required and it is free from the supervision of national governments. These statutes give the International Bank authority to engage in a number of kinds of transactions with central banks, some of

³⁴ Address of Gates W. McGarrah before the American Club of Paris, Feb. 12, 1931, *The Banker*, London, April, 1931, p. 21.

which the Federal Reserve banks have not been empowered to carry on under the Reserve Act. This is the type of foreign institution with which the New York Reserve Bank has carried on financial relations as "the central bank of the United States." These relations with the International Bank have been a continuance and expansion of the previous activity of the New York Bank as the representative of the Federal Reserve system and American financial interests in the international sphere.

Finance Loans to Central Banks

It was evident, in 1928, that large acceptance credits were being drawn to finance the movement and storage of unsold goods in central Europe and were purchased by the New York Reserve Bank.³⁵ Although the Reserve Bank is expected to buy only prime commercial bills, these acceptances were in reality finance bills. Such acceptances continued to be made and purchased by the Bank in succeeding years. Having taken them in the first instance the New York Bank then parceled them out to the other Reserve banks, thus involving the resources of the Federal Reserve system in these non-liquid assets. Such acceptance credits especially followed the inability to market long-term bonds in the United States.³⁶

When the European financial situation became very strained in 1931 on account of the banking crisis in Germany

³⁵ H. Parker Willis, "American Banking and the German Collapse," *The Banker*, London, September, 1931, p. 227.

³⁶ Several Federal Reserve banks reported that such curtailment of capital exports to central Europe through 1929 was a cause of the increase in acceptances arising from foreign storage and equipment. (See *Hearings on Banking Systems*, 1931, pp. 859-860.)

"German banks and for that matter other European institutions, finding their clients unable to float new obligations in this market, have obtained from bankers acceptance credits which they have used to cover the carrying of cotton, copper, flour and other staples in foreign warehouses. They have also been inclined to lean upon the American market for money with which to finance trade between themselves and other (non-American) countries. It has been a good deal cheaper for a German bank to finance the trade with Russia by the use of paper floated in the American market, than it has been for a bank in Nebraska to finance the trade between that State and the Eastern states." *Journal of Commerce* [New York], editorial, July 17, 1930.

the Executive Committee of the New York Reserve Bank held an all-day meeting at which members of J. P. Morgan and Company were in attendance.³⁷ At this meeting "it was decided that the Federal Reserve would follow the lead of the World Bank" in this crisis.³⁸ What was the lead of the "World Bank"? The board of directors of the Bank for International Settlements issued a statement to the effect that it had decided "in agreement with the other institutions concerned, to renew its participation in the rediscount credit previously accorded to the Reichsbank."³⁹ As a result the New York Reserve Bank made loans to the German Reichsbank by purchasing reichsmark acceptances in which all the other regional Reserve banks participated.⁴⁰

In connection with the "frozen" assets of certain European central banks, the New York Bank made other special loans in that year to the central banks in Austria, Hungary, and Great Britain.⁴¹ The amounts of the New York Reserve Bank loans to foreign central banks in 1931 were:

National Bank of Austria	\$ 1,083,000
National Bank of Hungary	5,000,000
German Reichsbank	25,000,000
Bank of England	125,000,000

As the loans were made the Reserve Bank gave a deposit credit on its books to the foreign central bank, which in turn gave the Reserve Bank a deposit of the same amount. The Reserve Bank then turned over the deposits to various American banks and ordered its own deposits abroad invested in "prime commercial bills" of the currency of the borrowing central bank.⁴² These bills were endorsed or guaranteed by the respective foreign central banks and it

³⁷ The New York Times, July 14, 1931.

³⁸ Idem.

³⁹ Idem.

⁴⁰ Annual Report of the Federal Reserve Bank of New York, 1931, p. 23.

⁴¹ See Annual Report of the Federal Reserve Bank of New York, 1931, p. 22; Federal Reserve Bulletin, August, 1931, p. 435; The New York Times, Aug. 2, 1931; Federal Reserve Bank of New York, Monthly Review for July, August, September, October, and November, 1931.

⁴² Annual Report of the Federal Reserve Bank of New York, 1931, p. 22; New York Herald Tribune, Sept. 13, 1931.

was agreed that ultimate repayment of the loans would be made in gold if necessary.⁴³ The bulk of these loans, \$125,000,000, went to the Bank of England. The purpose behind this loan, in which the Bank of France joined, was to relieve the pressure on sterling exchange. But what it amounted to was that the Bank of England shifted the burden of some of the "frozen" German credits from London to Paris and the Federal Reserve system.

Some of the "accommodation" which the New York Reserve Bank extended to European banks has not been repaid when due. The non-payment corroborated the lack of the commercial nature of such transactions to which these Federal Reserve operations were supposed to be confined and revealed their real "finance" character. In the case of foreign acceptances or loans held by the Reserve banks which were not paid at maturity, the New York Bank has followed the practice of renewing them.

Other Inter-Central Bank Relations

The New York Reserve Bank has had no regular business dealings with foreign commercial banks. It has confined its foreign relations to central banks and the Bank for International Settlements. The Reserve Bank has never sought a foreign account in its history.⁴⁴ The opening of its accounts with central banks has resulted from steps initiated by the foreign state banks of issue involved. After the Reserve Bank has investigated the foreign institution and approved of it the account has been opened.

Foreign central banks have not extended any loans or guaranteed credits to the New York Bank or any other Reserve bank. The Federal Reserve system's position has been so strong that no foreign aid was needed. It has always been a case of the American central banking organization lending to European institutions. The New York Reserve Bank has maintained deposit balances in foreign central banks and the latter have kept balances at the Reserve Bank. The Bank's deposits abroad have been quite nominal

⁴³ Annual Report of the Federal Reserve Bank of New York, 1931, p. 22.

⁴⁴ Hearings on Banking Systems, 1931, p. 92.

whereas foreign deposits in the Reserve Bank were relatively large. The reason for this difference is that the accumulation of central bank balances here was part of the program of foreign countries to stabilize their currencies, in doing which they set their monetary units at a certain relationship to the dollar.

Many of the foreign balances in the United States have been gold exchange balances which, under the laws of foreign countries, central banks have been authorized to count as part of their legal reserves.⁴⁵ But whether legal reserves or not all the different accounts were in reality actual reserves of the central banks. In this respect they were practically the same as the member bank reserves in the Federal Reserve banks. The New York Bank considered them gold balances and undertook to pay their owners gold on demand. Therefore, foreign central bank deposits in the Reserve Bank have been kept in liquid form, either book credits or short-term paper. In the case of foreign deposits held by the commercial banks, and for which they were called upon to supply gold, the banks would get it from the Reserve Bank as the only holder of gold in considerable amounts.⁴⁶

Definite written agreements have been concluded between the New York Reserve Bank and foreign central banks outlining what each bank is expected to do for the other bank in the purchase of acceptances in their respective markets.⁴⁷ As to the foreign-currency bills, the Bank has purchased these only through the central bank of the currency in

⁴⁵ Stabilization Hearings on H. R. 7895, 1926, p. 452. See Annual Report of the Federal Reserve Board, 1926, p. 16.

⁴⁶ Foreign short-term balances in America assumed very large proportions in the decade of the '20s. There are several reasons for this. Foremost among them was the universal confidence in the American dollar. The United States was on the gold standard and held an unprecedented stock of monetary gold. Its currency was relatively stable and foreigners could withdraw their balances in gold at any time. In contrast to this the economic conditions of many other countries were unsettled and their monetary systems disarranged. Furthermore, the billions of dollars loaned to foreign parties tended to increase foreign balances here; while at the same time a developing acceptance market and a stimulated stock market attracted surplus foreign funds. (For a detailed statistical analysis of foreign funds in the American market, see *The New York Money Market*, Vol. II, chapter XII, by James G. Smith.)

⁴⁷ Hearings on Banking Systems, 1931, p. 94.

question.⁴⁸ All the arrangements and the purchasing of acceptances for foreign account have been effected by the New York Reserve Bank on behalf of the Reserve system. As the agent of foreign central banks in the American market, the New York Bank has guaranteed the payment at maturity of purchased acceptances. So in effect the holding of acceptances for foreign account had the status of a guaranteed deposit. The Reserve Bank has not endorsed the acceptances. The guarantee has been in the form of a blanket agreement under which the Reserve banks assume liability, each according to its allotment of bills purchased, for their payment at maturity. For its service of buying and guaranteeing the acceptances, the Bank charges a small commission.⁴⁹

The coöperation of our central banking system with that of Great Britain has been effected by conferences between the governors of the New York Reserve Bank and the Bank of England. In the intervals between conferences the New York Bank has kept in close touch with London. Further coöperation between these two leading central banks has been achieved by their weekly exchange of cables concerning conditions in the money markets in New York and London, including advance notice of impending interest rate changes.⁵⁰

Although the Reserve Bank pays no interest on its foreign deposits, it will invest them for its correspondent central banks. Pursuant to directions from abroad, the Bank has rendered this service, purchasing bankers' acceptances and short-term treasury issues.⁵¹ Other services, which may be considered in lieu of interest, have included the safe-keeping and sale of securities, the purchase, sale, and earmarking of gold, the collection of checks and non-cash items, the domestic transfer of funds by mail or telegraph, and the payment of checks and drafts drawn on the Reserve banks.

⁴⁸ *Ibid.*, p. 91.

⁴⁹ *Ibid.*, p. 885. The commission charged has been one-eighth of 1 per cent.

⁵⁰ Stabilization Hearings on H. R. 7895, 1926, p. 975.

⁵¹ See Hearings on Banking Systems, 1931, pp. 883-885.

Earmarking

The practice of the New York Reserve Bank of earmarking gold for central banks, which commenced during the war, assumed huge proportions since 1924.⁵² By this practice the gold was segregated in separate vaults of the Reserve Bank, but ownership of the metal passed to the central bank concerned. In the form of gold bars (bullion), foreign gold coin, or United States gold coin, duly identified, it was held subject to the orders of the central bank whose property it was.

The importance of earmarking lies chiefly in its effect on the central reserves. When the New York Bank earmarked gold for the account of foreign central banks the reserves of our central banking system were reduced by the amount of gold earmarked, just as though the gold were exported. The opposite practice is known as "release from earmark." When a foreign central bank ordered its gold released from earmark it has usually been for the purpose of shipping it out of the country; and the exportation of it has followed.⁵³ However, this is not a necessary consequence and has not always been the case. When the gold released was not exported, it again became the property of the Reserve Bank and enlarged its reserves just as though gold were imported.

By the practice of earmarking, unheard of among central banks before the war, the New York Bank has settled some international balances in gold without shipping gold. Such settlements were effected by transferring on its books claims to the gold earmarked. When the New York Bank has come into possession of gold abroad it has sometimes had it earmarked there, largely in order to save the expense of

⁵² Annual Report of the Federal Reserve Board, 1932, p. 97. Here are shown figures on earmarked gold beginning with 1916. Some of the gold held in New York under earmark has at times been the property of member banks, but inasmuch as the earmarking of this gold has commonly been at the instance of foreign correspondents of these banks, the amount has been considered, on occasion, as part of the gold earmarked for foreign account. Federal Reserve Bulletin, December, 1927, p. 801.

⁵³ Department of Commerce, The Balance of International Payments in the United States, 1928, p. 52.

shipping to the United States gold that might later require reshipment.⁵⁴ Gold thus held abroad by the Bank was counted as legal reserve prior to February 4, 1921, but since then it has not been so counted.⁵⁵

At the conclusion of the World War the Federal Reserve Board envisaged an international gold clearance fund.⁵⁶ It had been cheered by the success of the Gold Settlement Fund which it operated for the Reserve banks in the United States, scattered as they are widely across a continent. It therefore announced its readiness "to undertake negotiations looking to the establishment of an international gold exchange fund." It suggested that it would probably be necessary in the beginning to confine affiliations with the fund to the United States, the entente allies, and to a few of the leading neutral nations, but thought it conceivable that all civilized nations might eventually be participants.

Foreign interests did not take up the idea, no doubt because of the uncertainty of availability of each nation's gold in the event of war, and it has lain dormant. However, by the New York Bank's earmarking operations, foreign nations entrusted their gold to the custody of an American institution. The Bank has in effect operated an "international gold exchange fund" of limited scope. A number of foreign central banks having accounts at the Federal Reserve Bank of New York availed themselves of this service.⁵⁷

Not all of the earmarking of gold for foreign account by the Federal Reserve system was done by the Federal Reserve Bank of New York. The New York Reserve Bank, however, did carry on almost the entire volume of such gold transactions. At the western port on the Pacific coast, the Federal Reserve Bank of San Francisco did no earmarking of gold for foreign account. The Federal Reserve Bank of Boston engaged in some earmarking operations, but that Reserve

⁵⁴ *Idem*.

⁵⁵ Federal Reserve Bulletin, December, 1927, p. 801.

⁵⁶ Annual Report of the Federal Reserve Board, 1918, p. 35.

⁵⁷ Another significant development involving international gold clearing is the Bank for International Settlements. It has avoided gold movements between countries in some cases by debit and credit entries on its books, thus operating an international gold clearance fund on a limited scale, but with possibilities of considerable expansion.

Bank had few transactions of that character.⁵⁸ The President's proclamation of March 6, 1933, and succeeding Executive orders of that year prevented the earmarking of gold as well as the exporting of it.

Representing American Interests Abroad

Representation of the Federal Reserve system in foreign financial affairs, was begun during the World War, and, as we have seen, the New York Reserve Bank then commenced functioning in this capacity. The breakdown of European monetary systems during the military conflict resulted in a need for their restoration. In the work of reconstruction and central banking development since the war the New York Reserve Bank became the American institution which determined the Federal Reserve system's foreign policy and wielded the power in international affairs. In the course of its history, the New York Reserve Bank has had relations with the central banks of no less than 37 countries⁵⁹ and the Bank for International Settlements. Foreign central banks and the New York Reserve Bank have made agreements among themselves by which credits have been shifted, and gold reserves supporting the bank deposits have been shunted to and fro, determining the capacity of the Reserve and foreign banks to expand and contract the superstructure of credit.

⁵⁸ For a few months during the years 1925, 1930, and 1931, at the request of one of its member banks, the Boston Reserve Bank earmarked gold for a foreign customer of that member bank (a South American government) in relatively small amounts varying from \$600,000 to \$7,500,000.—Letters from the Federal Reserve Bank of Boston.

⁵⁹ These countries are:

Argentina	Finland	Peru
Australia	France	Philippine Islands
Austria	Germany	Poland
Belgium	Greece	Portugal
Bolivia	Holland	Roumania
Bulgaria	Hungary	South Africa
Chile	Italy	Spain
Columbia	Japan	Sweden
Czechoslovakia	Java	Switzerland
Danzig	Latvia	United Kingdom
Denmark	Lithuania	Uruguay
Ecuador	Nicaragua	Yugoslavia
	Norway	

The foreign business the Reserve banks have done has been almost entirely that which has been dependent upon the engagements of the New York Reserve Bank with the foreign banks. The written agreements and oral understandings, expressed or implied, into which the New York Reserve Bank has entered with foreign central banks have in actual practice bound the other Reserve banks as well. In nearly all cases where accounts have been carried, the New York Bank has acted as the agent for the other Reserve banks.⁶⁰ In the business of dealing in acceptances and securities, the papers have been kept in the New York Bank while the balances were divided among the other Reserve banks, which shared in them proportionately.⁶¹

Governors of the New York Reserve Bank have held conferences with foreign central bank heads which were not authorized by the Federal Reserve Board.⁶² These officers have gone abroad and conducted negotiations in such a manner as to cause Europeans to infer that they represented the Federal Reserve system. Indeed, Governor Strong, in testifying before the United States Joint Commission of Agricultural Inquiry in 1921, referred to himself as "speaking for the Federal Reserve system."⁶³ Mr. Strong and Mr. Montagu Norman, governor of the Bank of England, went to Berlin in July, 1925, and held a conference with Mr. Hjalmar Schacht, president of the Reichsbank.⁶⁴ The particular purpose of the conference was not announced as it was said to be of a private nature. Following the conference it was reported that the Messrs. Strong and Norman informed Mr. Schacht that they were "satisfied" and "they could recommend German investments in America."⁶⁵ Though the central bankers' conferences in which officials of the New York Bank have participated have had no real official status, they have tended to create false impressions abroad

⁶⁰ Stabilization Hearings on H. R. 7895, 1926, p. 313.

⁶¹ *Idem*; Hearings on Banking Systems, 1931, p. 92.

⁶² Stabilization Hearings on H. R. 11806, 1928, p. 319.

⁶³ Hearings before the Joint Commission of Agricultural Inquiry, 67th Congress, 1st Session, 1921, Vol. II, Part 13, p. 788.

⁶⁴ *Deutsche Tageszeitung*, July 10, 1925.

⁶⁵ *The Commercial and Financial Chronicle*, July 18, 1925.

as to the capacity of the New York Bank's officers to speak for the system.

Although the Federal Reserve Board is not a bank and cannot engage in banking practice, the policy of the Federal Reserve system regarding foreign relations and the supervision of operations thereunder were the functions de jure of the central Board. In the course of central banking development, however, in so far as the Board has had any contact with central banks it has been indirect. The contacts have been made in the first instance by the New York Bank and have been maintained by it. The Board has had incomplete information regarding these negotiations and policies conducted on behalf of the Federal Reserve system. And when the Board has been informed it has generally been informed only through the New York Reserve Bank. The views of many well informed persons were expressed by a prominent Chicago banker.⁶⁶ In testifying before the Senate Banking and Currency Committee, the Chicago banker said he did not believe the Federal Reserve Board had had supervision over the foreign relations of the Federal Reserve system.⁶⁷

In the international field the New York Reserve Bank has not only handled the banking functions for all the Federal Reserve banks but has carried on as well the functions which, under the Reserve Act, devolved upon the Federal Reserve Board. The extent to which international relations of the Federal Reserve system have been in the hands of the New York Reserve Bank is seen in the far-reaching and disastrous 1927 easy money policy of the Federal Reserve system which was consequent upon the conference of central bankers in this country with the governor of the New York Bank. This policy was not the result of any deliberations of the foreign officials with the Federal Reserve Board. The foreign central bank heads met the Board members only socially through the courtesy of the governor of the Reserve Bank.

Another significant policy was the making of finance loans

⁶⁶ The late Melvin W. Traylor.

⁶⁷ Hearings on Banking Systems, 1931, p. 411.

to European central banks in 1931. In this case there are evidenced the following conditions as to the way in which the central banking system of the United States has developed:⁶⁸

1. That the foreign operations of the Federal Reserve system were handled by the Reserve Bank in New York for all the other Reserve banks.

2. That the disposition of the reserves of all the district Reserve banks was determined not only by the New York Reserve Bank but by the Bank for International Settlements in Basle, Switzerland.

3. That the disposition of the reserves of district Reserve banks for foreign use was determined not by the Federal Reserve Board but by the New York Reserve Bank.

4. That the decision in the New York Reserve Bank was made not by the board of directors, but the Executive Committee, presided over by the governor of the Bank.

5. That partners of a private international banking house joined the sessions of the Executive Committee of the New York Reserve Bank and that the official decision of the Reserve Bank was determined during such collaboration.

6. That the New York Reserve Bank in collaboration with a private international banking house, not the Federal Reserve Board, determined the policy to be followed by the Federal Reserve system.

Public purposes were proclaimed by the New York Reserve Bank in its effort to reestablish monetary systems in Europe. Under a régime of economic interdependence among nations, maintenance of monetary and business stability in foreign countries tends to promote domestic stability. Another public motive of the Bank's transactions to facilitate the establishment of monetary standards was the conservation of the world's monetary gold stock. On account of a decline in gold production coöperation among central banks was considered essential in order to support the superstructure of credit and aid world price stability.

In addition to public motives the coöperation of the New York Reserve Bank with foreign central banks has been

⁶⁸ See above, pp. 333-335.

undertaken apparently on account of private motives. Private motives are seen in the case of the "easy money" policy of 1927, and the finance loans to foreign central banks in 1931. The former satisfied those stock market and affiliated financial interests who wanted cheap Federal Reserve credit to promote speculation; and also aided New York financial groups in floating huge amounts of foreign securities in the United States. The finance loans of 1931 aided New York banks which held quantities of "frozen" German acceptances. The course of the New York Reserve Bank's policy during the above period in conjunction with the happenings in the stock market and the flotation of foreign securities would seem to indicate that private motives predominated.

Effect of Banking Act of 1933

Pursuant to the recommendations of the Senate Banking and Currency Committee, provisions for reënforcing the authority of the Federal Reserve Board over the system's foreign contacts and operations were incorporated into the Banking Act of 1933.⁶⁹ The Federal Reserve Act as amended by the new statute now provides that it is the duty of the Federal Reserve Board to exercise special supervision over all relationships and transactions of any kind entered into by any Federal Reserve bank with any foreign bank or banker, or with any group of foreign banks or bankers.

The Board is authorized to prescribe limitations and regulations governing the foreign transactions of a Reserve bank. An officer or representative of a Reserve bank may not conduct negotiations of any kind with officers or representatives of any foreign bank or banker without first obtaining the permission of the Federal Reserve Board. Furthermore, the Board is given the right, in its discretion, to be represented in any conference or negotiations by its own appointees. Finally, a full report of all conferences or negotiations, and all understandings or agreements arrived at or transactions agreed upon, and all other material facts appertaining to such conferences or negotiations, shall be

⁶⁹ Banking Act of 1933, section 10; Federal Reserve Act, section 14(g).

filed with the Federal Reserve Board in writing by a duly authorized officer of each Federal Reserve bank which shall have participated in such conferences or negotiations.⁷⁰

The new statutes indicate that Congress has charged the Federal Reserve Board with unequivocal and complete authority and direction over the foreign relationships of our central banking system or any component part of it. There is no limit to the extent to which the Board may exercise control over any foreign policy or transaction involving a Federal Reserve bank. The present law affects particularly the power exercised by the officials of the New York Reserve Bank in the past in collaborating with foreign central banks and bankers and steering foreign relations involving Federal Reserve policy along lines desired or determined by them (the officials of the New York Bank). Now that Congress has placed in the hands of the Federal Reserve Board complete authority, it remains to be seen whether the Board will control the foreign relationships of the Federal Reserve banks or whether these relationships will be largely controlled as in the past by the New York Reserve Bank.

⁷⁰ With a view to carrying out these new requirements, the Board has issued regulations governing the relations of the Federal Reserve system with foreign banks and bankers. See Regulations N, Series of 1933, published in Federal Reserve Bulletin, August, 1933, p. 505.

CHAPTER XVII

CONCENTRATION OF BANK RESERVES IN NEW YORK

The Intention of the Federal Reserve Act

Of all the evil conditions existing under the national banking system none were so persistently and vehemently denounced as the concentration of bank reserves in New York and their use in the call loan market for the financing of trading in securities. This entanglement of commercial banking reserves with the speculation and investment markets was attacked as the prime and pressing evil of banking and business. The financial breakdowns, money panics, bank runs, and even business crises which had befallen the American economic system were held to have found their inception in this alliance of the banks with stock speculation.

The remedy, therefore, for the dire consequences with which the people were periodically visited was sought by breaking the connection between bank reserves and the stock market. This was an overwhelming motive in the minds of some of the leaders in the banking reform movement. Those who sponsored the Federal Reserve Act expected that the organization and requirements for its operation which they prescribed would prevent the concentration of bank reserves in New York and their use in the stock market. The following statements indicate their ideas and expectations:

In the belief that the present reserve system is antiquated and unsatisfactory, that the massing of funds in New York and other financial centers of which so much has been said in recent years, is largely due to the present reserve requirements of national banks, and that in order to get the real benefit from the system of rediscount which has been proposed as a remedy for many existing evils, it is necessary to base such system upon an actual

control of reserves, provision has been made for recasting the present bank reserve system.¹ (From a digest of the first draft of the Glass bill furnished by Mr. Glass to the President.)

Upon these precise lines the bill is cast. Guided by the lamp of experience, taking note of the fact that, in time of emergency, clearing house associations in the great money centers, and even in smaller communities, repeatedly succeeded in arresting financial disaster, the House Banking and Currency Committee conceived the idea that regional organizations of individual banks throughout the country might effectually prevent disaster. Hence, the fundamental idea of the bill now presented is the creation of a new class of banks to be known as Federal Reserve banks.² (Carter Glass)

The whole fight of the great bankers is to drive us from our firm resolve to break down the artificial connection between the banking business of this country and the stock speculative operations at the money centers. The Monetary Commission, with more discretion than courage, absolutely evaded the problem; but the Banking and Currency Committee of the House has gone to the very root of this gigantic evil and in this bill proposes to cut the cancer out. Under existing law we have permitted banks to pyramid credit upon credit and to call these credits reserves. It is a misnomer; they are not reserves. And when financial troubles come and the country banks call for their money with which to pay their creditors they find it all invested in stock-gambling operations. There is suspension of payment and the whole system breaks down under the strain, causing widespread confusion and almost inconceivable damage.

The avowed purpose of this bill is to cure this evil; to withdraw the reserve funds of the country from the congested money centers and to make them readily available for business uses in the various sections of the country to which they belong.³ (Carter Glass)

The purposes of this great measure are:

First. To insure the stability of our commerce, of our manufacturing enterprises, of our industries, and the safety of our merchants and manufacturers and business men generally.
Second. To make available effective commercial credit for individuals engaged in manufacture, in commerce, in finance, and in business to the extent of their just deserts.
Third. To put an end to the pyramiding of the bank reserves of the country and the use of such reserves for gambling purposes on the stock exchange.

¹ Willis, *The Federal Reserve System*, p. 174.

² Congressional Record, Sept. 10, 1913, p. 4643.

³ *Ibid.*, p. 4648.

Fourth. To keep constantly employed the productive energies of the nation. ⁴ (Robert L. Owen)

Mr. President, one of the most far-reaching results which will follow will be the abatement of the nuisance of the national menace of the stock-gambling operations in this country, because this measure proposes to gradually withdraw these reserves, which have heretofore been pyramided in the three great central reserve cities. ⁵ (Robert L. Owen)

These typical expressions at the time of the establishment of the Federal Reserve system evidence the understanding of the situation and the intention of the Federal Reserve Act on the part of the proponents of the new central reserve organization. The projected Federal Reserve system possessed certain features upon which the sponsors of the Reserve Act relied in order to achieve the objects which they sought. The new organization was to comprise a number of regional central banks to hold the reserves of the member commercial banks. Reserves, therefore, were to be withdrawn from the correspondent banks in the "reserve" and "central reserve cities" and placed in the Federal Reserve banks. Accommodation to banks for seasonal requirements or other times of emergency was to be met by resort to the Federal Reserve banks rather than the correspondent banks.

Furthermore, the Federal Reserve system was to be a commercial banking system rather than a stock market or investment banking system.⁶ Liquid paper arising from current commercial transactions rather than notes secured by stock exchange collateral or merely investments was to be the principal asset of the member banks as a group. After the current requirements of its own community were taken care of, the average bank was to "invest" its avail-

⁴ Congressional Record, Nov. 24, 1913, p. 5994.

⁵ *Ibid.*, p. 5998.

⁶ In keeping with the intention and spirit of the Federal Reserve Act, the first governor of the Federal Reserve Board, Charles S. Hamlin, delivered an address before the American Bankers Association in 1914, in which he said: "The assets of these Federal Reserve banks, and the government deposits which may be made in them, will be pledged to strictly commercial uses and cannot be used for speculative purposes." The Commercial and Financial Chronicle, American Bankers Association Convention Section, Oct. 24, 1914, p. 87.

able funds in acceptances or commercial paper rather than the call loan market or stock exchange paper. Finally, the central bank method of testing and liquifying commercial credit was to be by the rediscounting of commercial paper rather than by lending on collateral. Paper drawn for the purpose of carrying or trading in business securities was forbidden rediscount at the central banks.

The Federal Reserve Act did not prohibit banks from carrying balances with correspondent banks. But the Act was drafted with a view to preventing the concentration of bank reserves in New York. Under the regional plan interior banks were to be related to the Federal Reserve bank in their district rather than to the correspondent banks in New York. It was presumed that inter-bank balances would dwindle to small proportions. Reserve city bankers feared that such would be the case. It was particularly supposed that balances would not be concentrated in New York, which belief induced the extreme hostility of the New York bankers to the Reserve Act.

The chief provisions of the Act by which the subjugation of the correspondent banking system was to be accomplished were these: Capital subscriptions to the Reserve banks were prescribed for all member banks. Bank balances, in correspondent banks after three years, could not count as legal reserve. Legal reserves had to be centralized in the regional central banks. Lastly, clearing and collection functions were to be performed by the Federal Reserve banks.

Inter-Bank Balances

Efforts were constantly made in the early years of the Reserve system to extend and improve clearing and collection operations and thereby relieve member banks of the necessity for keeping deposits in correspondent banks. Nevertheless, in spite of the provisions of the Reserve Act and the development of a nation-wide clearance system, banks still kept large balances in other banks and these balances have been especially concentrated in New York.⁷

⁷ For a statistical treatment of inter-bank balances since the establishment

The amount of bank deposits from other banks has in fact been much larger than it was in 1914. The following statement from Watkins, *Bankers' Balances*, emphasizes the continued importance of inter-bank deposits:⁸

In 1914 the 26,765 banks of the country reported deposits held for the account of banks and maintained with banks amounting to 2,705 and 2,873 million, respectively. By 1926 the total number of banks had increased to 28,146, the amount due to banks to 4,297 million, and that due from banks to 4,031 million.

Some member banks have held more deposits of other banks than deposits of individuals, firms, and corporations combined. Not only as a whole but for all classes of banks the amount of inter-bank balances has reached higher levels since the establishment of the Federal Reserve system.⁹

Although member banks are required to maintain their reserves in the form of deposits in the Federal Reserve banks, their deposits in correspondent banks have been near the level of non-member bank deposits in correspondent banks.¹⁰ But what is more significant, member banks have on the whole had deposits in correspondent banks which closely approximated their Reserve bank balances.¹¹ If country member banks alone are considered, they, during certain years, maintained deposits with correspondents exceeding their Federal Reserve balances by from 27 per cent to 51 per cent.¹²

The bankers' balances held by member banks located in the Federal Reserve bank cities have generally been in excess of the reserves of the twelve Reserve banks.¹³ The continued vitality of correspondent banking relationships

of the Federal Reserve system, see L. L. Watkins, *Bankers' Balances*, chapter IV; *The New York Money Market*, Vol. II, chapter X, by James G. Smith.

⁸ Watkins, *op. cit.*, p. 50.

⁹ *Ibid.*, chapter IV. See also *The New York Money Market*, Vol. II, pp. 203-210. Bankers' balances relative to total deposits of all national banks, from 1900 to 1930, declined. Bankers' balances relative to total deposits of all national banks, and of all member banks, from 1915 to 1930, declined, while those of state member banks increased.

¹⁰ Watkins, *op. cit.*, pp. 99-100.

¹¹ *Ibid.*, p. 100.

¹² *Idem.*

¹³ *Idem.*

is further evidenced by the fact that aggregate bankers' deposits held by all member banks have exceeded their reserves with the Federal Reserve banks by from 65 per cent to nearly 100 per cent.¹⁴ In the case of the New York City member banks, the chief point of concentration, the deposits of their bank clients were far in excess of their own reserve balances in the New York Reserve Bank—as much as 96 per cent more in 1924.¹⁵

The dominance of New York City as the holder of bank balances has not been lessened by the development of the central banking system. Indicative of the concentration of funds is the bank deposits of national banks in various cities. The bankers' deposits in the national banks of New York City, in 1926, were 939 million dollars. The city next in importance in this respect was Chicago which had 276 millions of such deposits.¹⁶ Although Chicago has gained substantially in importance, since 1914, as a correspondent banking center, still the concentration of bankers' balances there is relatively small in comparison with the concentration in New York.

Again, as a result of a statistical study in 1932, the continued importance of New York as a center for the concentration of bankers' deposits was shown.¹⁷ The concentration in the form of bankers' deposits relative to total deposits is slightly less than it was before the Federal Reserve system in all sections of the country. Nevertheless, New York City is not only just as important a point of concentration of bankers' balances relative to other centers as it was before the Reserve system, but slightly more so. Moreover, the New York City banks have gained as depositories for funds of banks throughout the country as a whole. Whereas other financial centers have gained in importance for their surrounding territory, particularly Chicago for the Middle West, New York City has become more important as a national depository center than before the Reserve system.¹⁸

¹⁴ *Idem.*

¹⁵ *Idem.*

¹⁶ *Ibid.*, p. 57. The figures are those at the midsummer report dates.

¹⁷ *The New York Money Market*, Vol. II, chapter X, by James G. Smith.

¹⁸ *Idem.*

Pyramiding of Reserves

It will be recalled that under the national banking system, the New York City national banks had to keep a 25 per cent gold reserve¹⁹ against their deposits. Since part of such deposits consisted of the legal reserves of banks all over the country, the 25 per cent gold reserve of the New York banks was at that time practically the ultimate reserve of the country's banking system. As was pointed out above, a substantial part of the legal reserves of non-member banks has been scattered in city correspondent banks as before the Federal Reserve system, and the concentration of such reserves in New York has continued. It was estimated in 1932 that approximately 20 per cent of the bankers' balances in New York City at that time was constituted of legal reserves of non-member banks.²⁰

In so far as the bankers' balances in the New York banks have consisted of the reserves of non-member state banks throughout the country, the ultimate reserve of the non-member banks under the Federal Reserve system has been located also in New York City. This ultimate reserve has been the 35 per cent gold reserve²¹ held by the Federal Reserve Bank of New York against its member bank reserve account. Moreover, this gold reserve has also been in practice an ultimate reserve against interior member bank deposits in the New York City banks. Although these balances in New York could no longer be counted as legal reserves, the depositing member banks looked upon them as reserves. The New York Reserve Bank's gold supported the huge amount of these secondary reserves from all sections of the country. The secondary reserves were treated as the equivalent of cash and in fact were withdrawn whenever desired without any trouble.

The pyramiding of reserves, therefore, has continued under the Federal Reserve system. It has worked in this way: Reserve deposits have been kept by interior non-

¹⁹ Considered here as a gold reserve because it was essentially gold although some so-called "lawful money" was included.

²⁰ The New York Money Market, Vol. II, p. 276.

²¹ Including some lawful money.

member "country" banks with "approved reserve agents" (correspondent banks) in Chicago, St. Louis, and other "reserve cities," and against such deposits the reserve agents in those cities have in turn maintained deposit balances with the New York City banks. Against the deposits of interior banks held in New York City member banks, the latter, in turn, have had to keep a reserve of 13 per cent, not in gold but in the form of deposit credit, in the New York Federal Reserve Bank. Thus we have had an integrated-chain bank-credit structure wherein bank credit served as a reserve for other bank credit.²²

As our banking has developed under the Federal Reserve system, pyramiding of reserves has not only not been eliminated, but the degree of pyramiding has actually increased. The old method of redeposited reserves with their concentration in New York has remained practically unchanged. Whereas under the national banking system, the New York City banks had to keep a 25 per cent gold reserve against their deposits, under the Federal Reserve system, they have had to keep only 13 per cent reserve against such deposits, and that not of gold, but of deposit credit in the Federal Reserve Bank. Upon the basis of this 13 per cent reserve, which itself was capable of a huge increase until the ratio of the Reserve Bank's gold to its deposits amounted to 35 per cent, it has been possible to effect the tremendous expansion in the superstructure of credit which has taken place by means of the central banking system.

Use of Bank Credit in Security Speculation: Brokers' Loans

With the continued dominance of New York City as a concentration point of the nation's bank reserves, legal and secondary, their use in financing speculation on the stock exchange has persisted. Large amounts of bank funds from interior banks have continued to be available to the "Wall Street" banks to loan at the money desk of the stock exchange. A direct relationship has generally existed between the brokers' loans of the New York City banks for their own

²² For a statistical survey of deposit credit pyramiding, see *The New York Money Market*, Vol. II, pp. 195-201.

account and the due-to-banks.²³ At times this relationship has been so close, as through the years 1926, 1927, 1928, and 1929, as to point to the conclusion that it has not been fortuitous.

The holding of deposits of interior banks in the New York City banks is only one form of concentration of bank resources in New York. Interior banks also send their funds to New York to be loaned directly on the stock exchange by the New York banks acting as their agents. This form of concentration in New York is reflected in brokers' loans for the account of out-of-town banks.²⁴ There was a huge increase in brokers' loans for the account of correspondents and out-of-town banks during the existence of the Reserve system, which increase reached its climax in 1929.²⁵

From the beginning of the Reserve system to October, 1929, there was a general rise in all classes of brokers' loans.²⁶ Such classes include loans made by the New York City banks for their own account, loans made by these banks for the account of out-of-town domestic banks, and loans for the account of "others."²⁷ The chairman of the House Banking and Currency Committee stated, in 1926, that the classes of brokers' loans of the New York City banks, those for their own account and for the account of out-of-town correspondents, which were \$500,000,000 in 1913, had increased to seven times that amount.²⁸ The significant fact is that not

²³ See Beckhart, *The New York Money Market*, Vol. III, pp. 148-153.

²⁴ Prior to 1926, there was no separate classification of loans for the account of out-of-town banks. The New York banks classified brokers' loans according to loans for their own account and loans for the account of "correspondents." Loans for "correspondents" represented, at the time of the establishment of the Reserve system, chiefly loans for out-of-town bank clients of the New York banks. Beginning in January, 1926, the loans to brokers, which the New York banks made as agents for their clients, were classified into loans for out-of-town banks (meaning domestic banks) and loans for "others." The loans for "others" came to occupy an increasingly important rôle, even exceeding the other two classes in amount.

²⁵ See Beckhart, *op. cit.*, pp. 81, 145, 159.

²⁶ *Ibid.*, Part I.

²⁷ "Others" refers to domestic and foreign corporations or firms, investment trusts, individuals, and foreign banks.

²⁸ Stabilization Hearings on H. R. 7895, 1926, p. 976. See also Hearings on Banking Systems, 1931, Appendix, Part VII, pp. 1020-1029.

During this period since 1913, the level of prices was higher than formerly.

only has the use of bank reserves for speculation not been lessened but that a much larger proportion of the nation's banking resources has gone into stock speculation and corporation security loans since the establishment of the Reserve system.²⁹

It must not be supposed that the New York banks were responsible only for the brokers' loans made for their own account. These banks were also largely responsible for the loans for the account of the out-of-town banks and for the "others." Their responsibility presents several aspects. The New York banks sought this business from the banks and business concerns throughout the country. A business concern or a bank that had "surplus" funds would be approached by a New York bank and asked to transfer their account to that bank. Suppose the amount was \$3,000,000. As an inducement to making the transfer, the bank would say, "We will lend \$2,000,000 of that on the call market if you will keep the other million on deposit with us."³⁰

The development of the brokers' loan business was due

There was also a general growth in industry and trade and an increase in the number of listed shares. Both of these factors would require a greater number of dollars to effect the turnover of a given volume of transactions. The question of whether the increase of bank credit in the New York security market, or the increase of bank credit which went into corporation securities generally, was out of proportion to the country's industrial development is capable of only approximate determination if at all and is not involved in this discussion. The subject at hand concerns the use of the nation's liquid banking resources in stock speculation or investment operations.

²⁹ See *Brokers' Loans Hearings*, 1928, pp. 1, 2, and 33; and appendix of the *Hearings on Banking Systems*, 1931, Part VII.

The peak of brokers' loans by the reporting New York City member banks was reached on October 2, 1929 when they totaled \$6,804,000,000. This amount was subdivided as follows: For own account, \$1,071,000,000; for out-of-town banks, \$1,826,000,000; for others, \$3,907,000,000. The total consisted chiefly of demand loans, that is loans on call. The figures were: time loans \$362,000,000; call loans, \$6,442,000,000. *Annual Report of the Federal Reserve Board*, 1929, p. 119.

Even more than the total of brokers' loans given above was used in financing trading on the New York Stock Exchange. The Stock Exchange reports brokers' borrowings, which include, in addition to loans made by the New York banks, loans by private banks, brokers, foreign banking agencies, etc. The peak of brokers' borrowings as reported by the New York Stock Exchange was \$8,549,000,000 on September 30, 1929. *Annual Report of the Federal Reserve Board*, 1929, p. 120.

³⁰ *Hearings on Branch, Chain, and Group Banking*, 1930, p. 723.

to the activity of the New York banks in going to business concerns and out-of-town banks and soliciting their funds to lend in the call money market at high rates.³¹ These organizations cannot get into the call money market directly. A Chicago banker, for example, cannot lend in the New York brokers' loan market without going through a New York bank. The mechanism of the market is such that all of these brokers' loans must be made by or through a New York bank.³² The New York banks connected American banks and other lenders with the stock market and received a commission for making such loans.

In the case of loans for the account of others, the New York banks' responsibility embraced more than soliciting the funds and acting as agents for the placing of these loans in the stock market. As a result of an investigation made for the Senate Banking and Currency Committee in 1931, the sources of brokers' loans for the account of "others" was determined.³³ The figures were obtained from seven large New York banks, as of the date when the largest volume of such funds was handled in 1929. These amounts accounted for approximately two-thirds of the total loans for "others" and were considered typical of the distribution of this class of brokers' loans. It was found that business corporations supplied 58 per cent of the total shown by the seven banks and investment trusts 8 per cent. Domestic corporations, therefore, furnished two-thirds of the loans for "others."

These domestic corporations obtained funds with the consent and assistance of the banks. The bankers were substantially interested in the investment trusts and actually owned outright their security affiliates. Many of the security affiliates were heavy lenders in the stock market. The flotation of securities of the corporations and investment trusts was financed by the banks directly or through affiliates.³⁴

³¹ Practically all of the brokers' loans which the New York banks made for the account of out-of-town banks and others were call loans. The small proportion of time loans made were for the New York banks' own accounts.

³² The bank may be a private bank as well as an incorporated one.

³³ See Hearings on Banking Systems, 1931, Appendix, Part VII, p. 1024.

³⁴ See H. Parker Willis, "American Banking and Investment Trust Problems," *The Banker*, London, January, 1928.

The commercial banks purchased relatively large amounts of corporation securities for their own account. In addition to purchases, the banks supplied funds to the security affiliates and investment banking houses by making collateral loans. By these methods the banks "carried" the securities until they could be sold to the public.

The "money" loaned on the stock exchange by the "others" did not come entirely from the earnings of the corporations or the proceeds of sales of securities to investors.³⁵ Bank credit furnished some part of the funds in the first place for such loans. The creation of bank credit financed part of the brokers' loans of the "others" in these ways: (1) corporation securities had been purchased by the banks with bank credit, (2) the "others" had borrowed funds from the banks which were loaned on the exchange, and (3) the purchasers of securities, from the "others" which made the loans, had borrowed to pay for them. To the extent that these means had enabled the "others" to make brokers' loans, the funds so loaned did not consist of savings but were the result of the creation of bank credit.

The New York banks were responsible for their loans to brokers for the account of outside banks and "others" in that they solicited bank and corporation deposits and stimulated speculation by promising a reward through loaning the funds on call at a profitable rate. Further responsibility attaches to the New York banks because they furnished in part the funds which the "others" used in turn to loan through the banks, and assumed a sort of contingent liability with regard to them which in fact became real.

As a result of the New York bankers' activity, loans for the account of "others" assumed increasing importance in the total of brokers' loans during the "new era" period preceding the stock market crash in October, 1929. They reached higher totals than the other two classes of loans combined, comprising nearly 60 per cent of the total of brokers' loans.³⁶ The New York banks made a handsome

³⁵ The New York Money Market, Vol. IV, Part I, p. 104, by B. H. Beckhart.

³⁶ See Annual Report of the Federal Reserve Board, 1929, p. 119 and Beckhart, The New York Money Market, Vol. III, p. 81.

In order to restrict the use of bank credit in the stock market, the Banking

income out of the system for they secured a commission or interest when they supplied corporations with funds, and again when they loaned these funds in the stock market for a commission. With the corporations and investment trusts loaning the proceeds of their financing on call through the medium of the banks, bank credit further fed the stock market boom.

The sponsors of the Federal Reserve Act expected that the new statutes and central banking organization would lessen the attractiveness of the call money market in New York. It was anticipated that the amount of credit available to the New York banks for lending on the stock exchange would be curtailed. Brokers' loans, made as they are by the commercial banks and used for securities speculation or for the carrying of unsold stocks and bonds, reflect the use of bank credit in such speculative operations. The record of the years shows how far the intention of the Federal Reserve Act failed of realization.

The only call money market in the country of national importance is the one in New York. Moreover, the Federal Reserve system has made the New York call money market more attractive than it ever was before the establishment of the central banking system.³⁷ Distance from New York was no barrier nor was the size of the bank a deterring factor. Even the banks in the Pacific coast section and the small country banks have been sending funds to loan on call in Wall Street.³⁸ The effect of sending funds from the country's banks to New York was to cause the local banks to turn to their respective Federal Reserve banks and borrow.³⁹ The

Act of 1933 decreed that: "No member bank shall act as the medium or agent of any non-banking corporation, partnership, association, business trust, or individual in making loans on the security of stocks, bonds, and other investment securities to brokers or dealers in stocks, bonds, and other investment securities." [Banking Act of 1933, Section 11 (a).] This statute strikes at the brokers' loans which the New York banks made for the account of others.

³⁷ Concerning the reason for this, see chapter XVIII, section on New York Call Loan Market versus Other Money Markets.

³⁸ See the following: Stabilization Hearings on H. R. 7895, 1926, pp. 680, 881; Hearings on Branch, Chain, and Group Banking, 1930, pp. 119-122; Hearings on Banking Systems, 1931, pp. 337-338; Monthly Review of the Federal Reserve Bank of New York, March 1, 1933, p. 34.

³⁹ Hearings on Branch, Chain, and Group Banking, 1930, pp. 119-122.

banks borrowed from their Reserve banks at a low rate and loaned money in New York on the stock exchange at a high rate.⁴⁰

Not only have surplus bank funds been sent to New York to loan on the stock exchange, but even bank credit which was needed to meet the requirements of the banks' local customers. Thus the chairman of the House Banking and Currency Committee stated:⁴¹

I called that to the attention of a banker friend of mine from the central west the other day, a section of the country which claims it greatly needs additional banking facilities to take care of the needs of farmers. He confessed to me that he was probably guilty in that respect, because during the period referred to⁴² his bank was loaning on call at New York to the extent of a million dollars.

A Federal Intermediate Credit Bank in a private statement reported the following:⁴³

Again, local funds for short-term loans to farmers seem to be particularly scarce at this time. *During 1929 such loans were scarce, because the banks could more profitably employ their funds in the call market*, but today the scarcity seems to be real. More and more we are finding that the Federal Land Bank is about the only source of new money for many farm borrowers.

Hon. Francis Seiberling of Ohio, member of the House Banking and Currency Committee, stated that he knew that such lending in the New York call money market was sometimes substituted for loans to commercial or industrial enterprises, which otherwise would have been made.⁴⁴

Further corroboration of the sucking of needed commercial credit into the speculative call loan market was given by the Comptroller of the Currency. The Comptroller, whose position as head of the examination function of national banks enabled him to know, testified before the

⁴⁰ Idem.

⁴¹ Stabilization Hearings on H. R. 7895, 1926, p. 881.

⁴² The year 1925.

⁴³ Quoted by H. Parker Willis in an article entitled "Restoring Bank Liquidity in the United States," *The Banker*, London, March, 1930, p. 411. The italics are those of the present writer.

⁴⁴ Hearings on Branch, Chain, and Group Banking, 1930, p. 726.

Senate Banking and Currency Committee in 1931 as follows: ⁴⁵

The Chairman (Senator Carter Glass). Does it not frequently happen that a commercial bank fails to accommodate its commercial customers in order that they may use the funds for call loans?

The Comptroller of the Currency (Hon. J. W. Pole). I have no doubt there are cases of that.

The preservation of the resources of the banks for paying depositors and meeting industrial, agricultural, and commercial requirements, which the Federal Reserve banks were designed to serve, therefore, has been prejudiced by the concentration of bank funds in New York and their use in stock speculation, just as before the Federal Reserve system. Banks in all sections of the country have continued sending funds to New York. In the first place, these banks sent funds to the New York banks for the interest obtained on their deposit balances, which balances the New York banks in turn loaned on the stock exchange. Secondly, the outlying banks loaned directly in the New York call money market at a higher rate using the New York banks as their agents. In the third place, the banks then borrowed from their Federal Reserve bank at a low rate and loaned in the New York call money market at a profit. Finally, some interior banks even curtailed needed accommodation to commerce, agriculture, and industry in order to make a greater profit by loaning on call in the New York stock market.⁴⁶

Reasons for Correspondent Banking and Concentration in New York

There are a number of considerations which account for the continued existence of the correspondent banking system, for a greater expansion of bank credit, and for the predominant concentration of bank reserves in New York City providing credit for stock speculation. The Federal Reserve

⁴⁵ Hearings on Banking Systems, 1931, p. 13.

⁴⁶ Concentration of bank resources in New York was also encouraged and aided by the management of the Federal Reserve banks with respect to their rate and acceptance policies. (See chapter XVIII, p. 375, section on The New York Call Loan Market versus Other Money Markets.)

Act did not require all bankers' balances to be kept on deposit in the Reserve banks but only the legal reserves. The Act reduced the legal reserve percentage requirements of national banks. In addition, deposits were classified into demand and time with the latter requiring a much smaller percentage than the former. This reduction in required reserves left a margin between the old and new reserve percentages from the start to seek employment or be deposited wherever the member banks chose.

A further reduction in legal reserve percentages for both demand and time deposits, in 1917, made available to member banks still more reserves which would be deposited in correspondent banks. In that year also all member bank reserves were required to consist of deposit balances in the Federal Reserve banks. The member banks transferred the portion of reserves held by them to the Reserve banks in part in the form of gold and lawful money and such transfers made possible further enlargement of bank credit.

During the existence of the Reserve system several influences have been at work which have had the same effect on the amount of actual reserves which member banks held as a lowering of the legal percentages. One of these is the rulings of the Comptroller of the Currency and the Federal Reserve Board. In every instance such rulings were in the direction of reducing reserve requirements, thus making for an expansion of bank credit and reserve balances.⁴⁷ Another factor was the issuance of Federal Reserve notes in exchange for gold. This practice which was begun in 1915, as an administrative variation from the law, was legalized in 1917. The revised procedure of issuing notes made possible a considerable expansion of bank credit.⁴⁸ Also the unprecedented gold imports swelled member bank reserves far above what they otherwise would have been; and the gold in conjunction with the lowered reserve requirements greatly multiplied the expansibility of bank credit.

In addition the banks had "extra" reserves to deposit where they chose because of a shifting of demand deposits

⁴⁷ Stabilization Hearings on H. R. 7895, 1926, p. 371.

⁴⁸ See chapter X, pp. 204-205.

to time deposits. The reserve percentage for time deposits was lowered in 1917 from 5 per cent to 3 per cent and there has been no reduction since then. But many banks got their customers to shift their demand accounts to a time basis. This practice went on continuously after 1917 and had the effect of enlarging the actual reserves. Time deposits increased much more rapidly than demand deposits.⁴⁹ The importance of this shift was shown as a result of an inquiry made by the Federal Reserve Bank of New York. It was held that about 55 per cent of the increase in bank deposits that occurred during nine years was represented by an increase in time deposits which required only a 3 per cent reserve.⁵⁰

Finally, the average banker was less inclined to assume responsibility for the strength of his own position. He tended to cut his vault cash and surplus legal reserve balance to the minimum and depend upon the central bank when in need of funds. The need of a bank to keep an excess reserve and till money was removed because of (1) the reduction of money in circulation by the increased use of deposit currency, (2) the smooth working of the Reserve system in effecting transfers of funds and clearances, (3) the increased velocity of circulation of money and credit, and (4) the ability to borrow and secure cash quickly, facilitated especially by the wire transfer system.⁵¹ Thus

⁴⁹ See B. M. Anderson, Jr., "Bank Expansion vs. Savings," *The Chase Economic Bulletin*, June 25, 1928, pp. 12-16.

⁵⁰ Stabilization Hearings on H. R. 7895, 1926, pp. 370-371.

In a statement before the House Banking and Currency Committee, Mr. Strong, governor of the Federal Reserve Bank of New York, said: "Nobody can tell to what extent, because of the inducement of a larger profit to the member bank in getting accounts transferred from a regular checking account to some form of time deposit requiring but 3 per cent reserve, how much of the really check deposit balances of the banks of the country are in fact being carried on a 3 per cent reserve. That is a material reduction in the reserve of the banking structure. It would require a very careful analysis of just how each bank classifies these accounts and what kind of contracts it makes with its depositors to get a correct understanding of this, but there is a subtle and very important change that has taken place in the banking structure." Stabilization Hearings on H. R. 7895, 1926, p. 371.

⁵¹ Concerning the circulation of money under the Federal Reserve system, Dr. A. C. Miller of the Federal Reserve Board testified before the House Banking and Currency Committee as follows:

Dr. Miller. There is no country in the world, probably, where the rapidity

the very existence and operation of the Reserve system itself tended to reduce the actual amount of reserves required and to enlarge correspondent bank balances.

Another explanation of reserve balances in correspondent banks is found in the nature of American banking. Because of the dual banking organization it has been possible for the forty-eight state governments to determine where the legal reserves of their respective state banks could be kept. Under state banking laws, non-member state bank reserves either were required to be held or might be held in other banks.⁵² In nearly all cases the statutes of these states permitted deposits in the New York City banks to be counted in the required reserves.

In the case of state banks which were members of the Federal Reserve system, they were obliged to conform to the reserve requirements for national or member banks. But most of the state banks—thousands of them—were outside the Reserve system. These non-member state banks have been keeping some or all of their legal reserves in correspondent banks, or “approved reserve agents,” as the state statutes and banking regulations commonly refer to them. Thus the correspondent banking system has continued to perform the function of reserve depositories for non-member banks, just as it did for all banks before the Federal Reserve system.

Following the passage of the Federal Reserve Act, there

of turnover of money is as great as it has become in the United States under the Reserve system.

The Chairman. Velocity, I think it is commonly referred to.

Dr. Miller. Velocity, or, as I would prefer to call it, efficiency of performance of the monetary unit of value under the operation of the Federal Reserve system. The American dollar has become an efficiency marvel. Currency, we will say, is retired from circulation in San Francisco today. Tomorrow it is loaned on call in New York City. This means that the San Francisco member bank gets credit in its reserve account with the Federal Reserve Bank of San Francisco on the day it deposits redundant currency, immediately arranges for a transfer wire to New York, and it is out on call tomorrow. Stabilization Hearings on H. R. 11806, 1928, p. 175.

⁵² For the provisions of state laws relating to reserve requirements of state banks, see the following Federal Reserve Bulletins: Vol. III, p. 768 (October, 1917); Vol. X, p. 154 (March, 1924); Vol. XIV, p. 778 (November, 1928); Vol. XVI, p. 570 (September, 1930).

was a lowering of reserve percentage requirements, but the proportionate amount that state laws permitted state banks to carry with correspondents remained approximately the same.⁵³ Besides, state laws permitted state banks to include Federal Reserve notes in their legal reserves. All of these factors tended to release more funds available for transfer to New York. In addition to the legal and secondary reserves of non-member state banks, the secondary reserves of national banks and state member banks continued, under the Federal Reserve system, to be deposited in correspondent banks, chiefly in New York.

One reason why banks kept reserves on deposit in correspondent banks and not in the Federal Reserve banks has been the rate of interest paid on deposits by the commercial banks.⁵⁴ The New York correspondent banks have competed with those of other cities for the holding of the reserve balances, legal and auxiliary, of the interior banks.⁵⁵ In this competition the New York banks have continued to hold the dominant position as we have seen. The chief magnet in New York has been the stock market with its financial tributary, the call loan market. Because of this speculative market, the New York banks have been able to provide a highly profitable outlet for bankers' balances and to pay an attractive rate of interest on them, just as before the Federal Reserve system. American banks have seen fit not to resist the temptation to send their reserves to New York for the interest paid by the "Wall Street" banks.

The city correspondent banks have also rendered a number of services to their bank clients, some of which could not

⁵³ See Annual Report of the Federal Reserve Board, 1915, pp. 104-113; Federal Reserve Bulletin, March, 1924, pp. 154-181.

⁵⁴ This motive for the maintenance of deposit concentration in New York and other reserve city banks was considerably lessened by the Banking Act of 1933. This act [Section 11 (b)] prohibited any member bank from paying any interest on demand deposits, with certain exceptions applicable to foreign countries, mutual savings banks, and public deposits. Nearly all the correspondent banks in New York, Chicago, and other reserve cities are member banks. So this new law tends to curtail the amount of bankers' balances in correspondent banks. And as for time deposits, the same act [Section 11 (b)] charges the Federal Reserve Board to limit by regulation the rate of interest which member banks may pay on such deposits.

⁵⁵ See Stabilization Hearings on H. R. 11806, 1928, p. 128.

be obtained from the Federal Reserve banks. The most important service which interior banks have obtained from city correspondents in New York and other centers is loans. Non-member banks have not been permitted to borrow from Federal Reserve banks except for a brief period during and immediately following the World War. Consequently they have relied upon their city correspondents for loans. Some member banks in certain seasons of the year have made more loans to correspondent banks than they made to their local customers. A number of city banks, especially in New York but in other cities also, have done a large volume of such business with their correspondents. Although not lenders of last resort, they have been virtually banks of rediscount, performing this function for their correspondents as Federal Reserve banks have done for their members.

Perhaps the most striking aspect in which correspondent banking relationships have been different from that intended by the framers of the Federal Reserve Act is the borrowing by member banks from their city correspondent banks. The volume of such loans has been considerable when compared to the volume of member bank borrowings from the Federal Reserve banks.⁵⁶ The correspondent banking relationship has been particularly attractive to banks because they could borrow from the city banks on paper of types collateralized with corporation securities, which were ineligible for discount at a Federal Reserve bank.⁵⁷

⁵⁶ The continued importance of correspondent bank loans to banks which were members of the Federal Reserve system is shown by the following examples: On December 31, 1929, "country" member banks had bills payable with the Federal Reserve banks amounting to \$137,000,000, and with correspondent banks amounting to \$105,000,000. (Federal Reserve Bulletin, March, 1930, p. 136). On September 30, 1932, "reserve city" member banks had bills payable and rediscounts with Federal Reserve banks amounting to \$76,000,000 and with correspondent banks amounting to \$93,000,000. Federal Reserve Bulletin, December, 1932, p. 782.

See also *The New York Money Market*, Vol. II, pp. 222-227, 238-240.

⁵⁷ Thus one country bank borrowed \$100,000 from the Chase National Bank in New York instead of the Federal Reserve Bank of New York. The country bank could borrow from the Chase National Bank at the same rate as that charged by the Reserve Bank or sometimes a little higher, and particularly, it borrowed on railroad bonds or other securities on which it could not borrow from the Federal Reserve Bank. *Hearings on Brokers' Loans*, 1928, p. 87.

Throughout the existence of the Reserve system, American banks, member and non-member alike, have borrowed from their correspondents in New York.⁵⁸ In order to obtain loans, the interior banks were required to build up a "borrowing equity," as the New York banks called it; that is they had to keep a satisfactory amount on deposit in order to borrow the desired amounts.⁵⁹ New York City banks have usually required their correspondent bank clients to keep a minimum balance equal to about 20 per cent of the bank's borrowings. Some of the large New York banks, such as the Chase National which held balances from over 7,000 banks, were in an especially favorable position to loan to their correspondents funds which the latter, considered as a group, had deposited. But if the New York banks lacked sufficient funds to meet the needs of their bank clients over the country, they borrowed from the Federal Reserve Bank of New York and thus supplied the credit.

Another service which attracted bank deposits to New York is that of safekeeping of securities. The custody service of the Federal Reserve banks has extended only to member banks and has embraced only securities owned by the member banks. The New York commercial banks, in addition to such services, have held for safekeeping the securities of non-member banks and those of the customers

⁵⁸ Hearings on Branch, Chain, and Group Banking, 1930, pp. 1892-1893; Hearings on Banking Systems, 1931, p. 269.

⁵⁹ The relationship between the bank balances with a New York correspondent bank and its loans to bank clients is illustrated by the experience of the Chase National Bank of New York in 1920 and 1921. The following figures relate to fifty-nine state and national banks, among the thousands which kept deposit balances with the Chase bank. The fifty-nine banks were located in the South from coast to coast and in the West from Canada to Mexico as far east as the Mississippi Valley including a few in Ohio and Indiana. Banks in the larger centers were not selected. Otherwise the fifty-nine banks were reported to have been picked at random. (Hearings on Branch, Chain, and Group Banking, 1930, p. 1893.)

	Balances	Loans
January, 1920	\$1,426,400	\$ 459,200
September, 1920	1,215,800	1,057,500
October, 1920	1,221,200	1,677,800
November, 1920	1,091,800	1,346,400
December, 1920	754,200	801,500
January, 1921	759,200	951,300

(individuals, firms, and corporations) of member and non-member banks. Interior banks, member and non-member alike, have, for two chief reasons, found it advantageous to have a New York correspondent bank connection to obtain this service.

With such a connection interior banks have been enabled to borrow almost instantly. By telephone or telegraph they have arranged with their city correspondents to credit their accounts with a certain amount, using securities in custody as collateral.⁶⁰ Secondly, by having the securities held in New York, interior banks and their customers have been able to sell them in the national security market whenever they wished. When the securities were sold the proceeds were made immediately available to them if desired by telegraphic transfer.

The New York City banks have rendered a number of other services for their correspondent banks in connection with the investment of their funds. They made inquiry regarding the advisability of various credits and drew upon their extensive statistical and credit departments to furnish information to the interior banks. Upon request "investment counsel" was given concerning the purchase and sale of securities. Interior banks have preferred to buy and sell securities, especially unlisted issues, through their New York correspondent bank rather than to deal directly with a broker.⁶¹ The New York banks allotted their clients participation in new security issues and acceptance financing and purchased for their account acceptances and commercial paper. They facilitated the investment of secondary reserves in commercial paper by analyzing its worth and collecting it at maturity. Brokers' loans on the stock exchange also were handled for interior banks in record breaking amounts as was noted above. The New York banks held

⁶⁰ See Hearings on Brokers' Loans, 1928, p. 87.

Where a member bank had government securities in custody at a Reserve bank, it was able to borrow with similar convenience and dispatch. But in the case of member banks *rediscounting* with their Federal Reserve bank, it was necessary to gather the desired amount of eligible paper and send it to the Reserve bank.

⁶¹ In so doing the New York bank's own broker handled the transactions.

the collateral and handled all details about these loans for the interior banks. Finally, the New York banks collected interest coupons and credited the accounts of the correspondent banks. These "investment services" have been of considerable influence in maintaining balances in the New York correspondent banks.

Certain aspects associated with the development of the clearing and collection system have also made it advantageous for banks to carry balances with correspondent banks in New York and other reserve cities. Non-member banks which decline to remit in acceptable funds to Federal Reserve banks and operate on a non-par collection basis, cannot use the Federal Reserve system as a collection agency. The number of banks which have preferred to deal with city correspondents for clearance purposes has comprised most of the non-member banks. By using city correspondent banks, the interior banks have in most cases been given immediate or earlier credit than was given by the Federal Reserve banks. The New York City banks have been giving immediate credit.⁶² Interior banks have also been permitted to send transit items in batches instead of sorting them according to the time collection schedule and keeping their general ledgers on a deferred account basis.⁶³ Again, some collections are more simply and quickly effected by means of inter-bank debits and credits than by putting them through the Federal Reserve clearance system.⁶⁴ Furthermore, in the case of those non-member banks which have refused to remit at par, banks chiefly in the South and West, they have also derived a profit in exchange charges.

The Federal Reserve system has largely done away with the need of maintaining city bank balances to furnish domestic exchange. However, owing particularly to the dual banking structure with thousands of non-member state banks, and a substantial part of them not remitting at par,

⁶² See Watkins, *Bankers' Balances*, pp. 137-139.

⁶³ While the large New York banks have given their correspondents immediate credit, they have not been willing that the Federal Reserve banks give immediate credit.

⁶⁴ For some examples of such action, see *The New York Money Market*, Vol. II, pp. 234-237.

domestic exchange on banks in New York, Chicago, and other reserve cities has continued to be supplied to some extent. As far as foreign exchange is concerned the need of foreign balances has been lessened by the development of the American acceptance market. Nevertheless, during the existence of the Federal Reserve system, hundreds of millions of dollars have been required annually for payments abroad.

The Federal Reserve banks have not established branches abroad on which interior banks could buy foreign exchange. Such facilities not having been established, the Reserve banks have done very little to supply foreign exchange. Not being able to secure exchange from the Reserve banks, the interior banks have continued to secure it from their correspondent banks in the larger centers which banks have depended chiefly upon foreign banks. The bulk of foreign exchange has been sold by the New York City member banks. In order to obtain this exchange for their customers and the counsel and service that have accompanied it, the interior member as well as non-member banks have maintained balances in New York.

In the case of a member bank, it need not have kept a balance with a correspondent bank. The member bank could have paid for the exchange with a check on its Federal Reserve bank. But member banks have found it more convenient and more profitable to maintain a balance with the correspondent bank furnishing the exchange and to pay by having this account debited. By this method it has also been possible at times to render service to customers more quickly. The correspondent banking system has owed its existence during the Federal Reserve period in part, therefore, to the city banks' facilities for supplying domestic and foreign exchange.⁶⁵

⁶⁵ In the hearings before the Senate Banking and Currency Committee in 1928, it was brought out by a member of the Federal Reserve Board that the New York City bankers served their correspondent bankers also by buying them theatre tickets and entertaining them in various ways when they went to New York. *Hearings on Brokers' Loans*, 1928, p. 87.

The publisher of a mid-western banking journal conducted a survey concerning the relative merits of the correspondent banking system and the Federal Reserve system. About 2,000 questionnaires were answered. In reply

The various considerations discussed above have tended to maintain the usefulness of correspondent banks, in spite of the Federal Reserve banks, to member as well as non-member banks, and to continue the predominant concentration of bank reserves in New York City. A few of the New York banks developed financial connections national and world-wide in scope. Particularly on account of their contact and experience with foreign trade financing and the national and international security markets, they have offered to American banks profitable employment of reserves and valuable services. The New York institutions have provided a broad correspondent banking service which smaller banks in other cities have not been in a position to equal.

to the question: What is the most unusual service a correspondent bank ever rendered you? some answers were: Offered to do our Christmas shopping; secured costumes for a home talent play; acted as detective in locating a man we were looking for; secured theater and athletic tickets we couldn't hope to get. The New York Herald Tribune, March 7, 1928.

See also Hearings on Branch, Chain, and Group Banking, 1930, pp. 1890-1891.

CHAPTER XVIII

BANKING AND MARKET RELATIONSHIPS

Use of Central Reserve Credit in the Stock Market

The Federal Reserve Act was enacted with a view to keeping the central reserves of our banking system out of the investment security market. Federal Reserve banks were denied the right to purchase industrial, railroad, or public utility stocks and bonds. The Act also prohibited the regional central banks from rediscounting commercial paper collateralized with corporation securities.

Federal Reserve credit was to be kept out not merely of the so-called speculative security market, but of the capital market in general. That is why the statute read "carrying or trading in stocks, bonds, or other investment securities" ¹ instead of saying "speculative operations" or "speculative securities." It had been expected not only that the resources of the Federal Reserve banks would not be loaned on stock market collateral, but that our central banks would be managed in such a way that no central reserve credit would be used even indirectly in financing trading on the stock exchange.

The original Federal Reserve Act contained no prohibition against the use of the central reserves for investment and speculation operations when the use of such reserves was obtained by borrowing on member bank promissory notes with government securities as collateral. An obvious reason for this was the fact that borrowing on member bank promissory notes was not permitted. The only way a member bank could borrow under the original Act was by rediscounting eligible paper.

It is true that under the original Act customers' notes were permitted to be rediscounted by member banks at a

¹ Federal Reserve Act, section 13.

Reserve bank when such notes were given for the purpose of carrying or trading in United States Government securities. But at the time the Federal Reserve Act was enacted, the Federal Government debt was small, indeed insignificant as compared to what it later became. It was, therefore, probably assumed that the limitation of obtaining central reserve credit supporting investment operations to only those in United States Government securities was practically tantamount to prevention of the use of central bank reserves for investment or speculation operations in stock market securities. Otherwise, it will be recalled, rediscounts were restricted to paper arising out of agricultural, commercial, or industrial transactions. Moreover, the Act contained specific prohibition against obtaining central reserve credit in order to carry or trade in corporation securities.

Indeed, when Senator Glass was presiding over the investigation of the operation of our banking system in 1931, he informed the governor of the New York Reserve Bank of the attitude of those who, in 1913, sponsored the Federal Reserve Act as follows: ²

As a matter of fact, you could not lend them on bonds at all if, at that time the proponents of the Act had ever had any conception of the fact that there would be billions of dollars of outstanding United States bonds. You know when the Act was passed there was less than \$1,000,000,000 of outstanding United States bonds and they were rapidly disappearing. We never would have included the right to use United States bonds as collateral for those purposes, but for the fact that they were at that time rapidly disappearing.

The World War and the amendment to the Reserve Act of September 7, 1916, furnished a turn of events which fundamentally altered the character of the banking system. This was the amendment which permitted member banks to borrow on their promissory notes collateralized by government securities. By possessing "governments" the banks have been able to gain access to Federal Reserve credit regardless of what kind of paper they held. The incentive for possessing short-time liquid commercial paper as a basis

² Hearings on Banking Systems, 1931, p. 53.

for rediscounting was removed. Consequently, Federal Reserve credit was drawn upon to sustain an ever-increasing volume of bank loans on the stock exchange and customers' security loans, largely by borrowing on government securities.

In addition to borrowing on government bonds, Federal Reserve credit was used to finance security trading indirectly in another way. To some extent the banks rediscounted eligible commercial paper and used the proceeds for loans in the security market.³ A number of times during congressional hearings bankers have admitted that Federal Reserve credit was used in stock market speculation. It was brought out in one of such hearings during the questioning of the president of the National City Bank of New York⁴ that this bank had borrowed from the Federal Reserve Bank for the purpose of loaning on the stock exchange. The bank head defended the practice and held that the Federal Reserve banks were established for that purpose.⁵

The president of the National City Bank declared: "Frankly in the conduct of our bank I have never felt quite happy unless we have a volume of about \$100,000,000 of demand street loans."⁶ Then he pointed out the relationship between the call loan operations of the National City Bank, during 1929 and 1930, and its borrowings from the Federal Reserve Bank of New York during that period.⁷ At times during the "new era," the National City Bank had borrowings from the Reserve Bank of considerably more than \$100,000,000 and had over \$250,000,000 loaned on the stock exchange.

During the investigation of the banking situation conducted by the Senate Banking and Currency Committee in 1931, the head of the Chase National Bank,⁸ the largest of the New York banks at that time, did not deny that member

³ *Ibid.*, pp. 289, 303.

⁴ Charles E. Mitchell.

⁵ See Hearings on Branch, Chain, and Group Banking, 1930, p. 1999.

⁶ Hearings on Banking Systems, 1931, p. 289.

⁷ *Idem.* For a chart showing this relationship, see same hearings, opposite p. 322.

⁸ Albert H. Wiggin.

banks used Federal Reserve credit for stock market purposes. In fact he held that he did not see how the Federal Government could prevent a member bank from borrowing "money" from a Federal Reserve bank in order to lend on the stock exchange.⁹ The bulk of borrowing from the Reserve banks has been by means of member bank promissory notes collateralized with United States Government securities.¹⁰ This method of borrowing has been particularly predominant in securing central reserve credit from the Federal Reserve Bank of New York.

Federal Reserve funds were drawn into the stock market in large volume, particularly in 1919 and the first few months in 1920, and during the "new era," 1925-1929. The use of Federal Reserve credit in security speculation during the post-war period gave Federal Reserve officials considerable concern. In reporting a conference of the Federal Reserve Board and governors of the Reserve banks regarding such use, in the fall of 1919, the press had the following to say as to the conclusions of the Board on the subject:¹¹

Never again will the credit facilities of the Federal Reserve banks be used for speculative purposes to the same extent as marked the operations of the banks in the New York district during the past month.

This resolution on the part of the Federal Reserve Board apparently has been stamped upon the minds of the governors of the twelve Federal Reserve banks, who have been in session here for the past few days. It has been made clear that the Board officials firmly believe that more of the Federal Reserve credit facilities in the New York district were being used for stock market operations than for carrying on of bona fide business transactions. It has been made clear also that there could not be a repetition of this situation without general business suffering, and it has been made emphatic that in no event will this be permitted to occur.

The far greater extent to which the reserves of the central banks were used for stock market speculation during the period immediately preceding the crash of October, 1929, furnishes ironical comment on conditions in the operation of

⁹ Hearings on Banking Systems, 1931, p. 185.

¹⁰ For chart showing borrowings, see *The New York Money Market*, Vol. IV, p. 322.

¹¹ *The Commercial and Financial Chronicle*, Nov. 22, 1919, p. 1933.

our banking system which can scarcely be equaled in American history.

The New York Call Loan Market versus Other Money Markets

It was pointed out in the preceding chapter how the bank reserves came to be available, why they were deposited in correspondent banks, and why they concentrated in New York City. Federal Reserve policy with respect to interest rates and acceptances also tended to draw funds to New York and to play into the hands of the stock market interests.

The belief had been held that the call loan market would lose its attractiveness because stock-exchange paper was ineligible for rediscount at the Federal Reserve banks. It was expected that banks would discriminate against the loans collateralized by securities and in favor of paper arising out of current business transactions. By possessing a portfolio of the latter paper the banks were to be in a position to convert their assets into cash at the Reserve banks at any time or restore or enlarge their legal reserves if necessary.

The provision in the Federal Reserve Act granting acceptance powers to national banks was designed to furnish an "investment" for banks which would compete successfully with the call loan. In lieu of brokers' loans, the framers of the Federal Reserve Act had expected that secondary reserves would be invested in commercial paper and bankers' acceptances, which investment would be facilitated by the development of local money markets. It had been intended that each of the Federal Reserve banks was to have its own funds which were to be kept in its district. The growth of local money markets centering around the regional central banks, however, was inhibited by influences tending to draw funds to New York and to concentrate the acceptance business in that city.

The bulk of the bankers' acceptance business has been centralized in New York City. The fact that New York has been the outstanding foreign trade port of the United States contributed a good deal to the centralization of the acceptance business in that city. However, probably more of this acceptance business originating in other commercial

centers would have been retained there (1) if the Federal Reserve Bank of New York had not rendered the liberal fostering care that it did, and (2) if other Federal Reserve officials had not coöperated in a special effort to centralize acceptance financing in New York.¹²

In an effort to develop the New York discount market, the Federal Reserve Bank of New York kept its buying rate for acceptances relatively low. This encouraged resort to the acceptance method of financing on the part of borrowers. Drawers of acceptances all over the country sent them to New York. The low rates of the New York Reserve Bank, its policy of buying freely, and its resale agreement system,¹³ in effect a secured loan to acceptance dealers, made a profit for the dealers and aided them in carrying the acceptances.¹⁴

A tendency toward uniformity of discount rates among the different Federal Reserve banks has been fostered by the administration of the Reserve system. Particularly, since the war there has been a greater similarity among these rates than was probably warranted by the economic development of the respective regions. In fact at times the same discount rate has been in effect at all twelve of the Federal Reserve banks, whereas the actual interest charges paid by customers on their bank loans varied considerably among the different Federal Reserve districts. The effect of this tendency toward interest rate uniformity which has been promoted was to shift funds from the various parts of the country to New York and its stock market.¹⁵ The reason for this effect is that money tends to flow away from the place where

¹² See Annual Report of the Federal Reserve Board, 1920, p. 49.

¹³ For details concerning the resale agreements of the Federal Reserve banks, see Beckhart, *The New York Money Market*, Vol. III, pp. 389-407.

¹⁴ The bulk of resale agreements "are entered into with the Federal Reserve Bank of New York. There the dealers carry from 50 to 65 per cent of such portfolios as they maintain, on the basis of resale agreements." *The New York Money Market*, Vol. III, p. 389.

¹⁵ See Stabilization Hearings on H. R. 11806, 1928, p. 129.

An influence in the Federal Reserve rate structure is the market for federal funds. Banks in one Federal Reserve district can circumvent their Federal Reserve discount rate by buying federal funds in another district where the rate is lower. The effect of such a practice is toward a uniform rate structure. (See B. C. Turner, *The Federal Fund Market*, pp. 81-84; Hearings on Banking Systems, 1931, p. 96.)

the official interest rate is below the economic rate. Uniform bank rates in the various Federal Reserve districts mean in effect a higher rate in New York and money is attracted there.

The other Reserve banks have, on the whole, kept their acceptance buying rates at or nearly as low as the buying rates of the New York Reserve Bank. There has been a tendency toward uniformity of acceptance rates just as there has in the case of discount rates.¹⁶ Banking interests in New York City have desired this. Likewise there has been strong pressure on their Reserve banks from the borrowers in other Federal Reserve districts to offer credit at as low rates as was being obtained by borrowers in the New York district.¹⁷

The policies of both the New York Reserve Bank and the other Reserve banks considered together, therefore worked to the same end, viz., the concentration of funds and the centralization of the bankers' acceptance business in New York. Thus when acceptances could not be had from their local institutions, the other Reserve banks again resorted to New York and purchased them from or through the New York Reserve Bank. The spare funds of the regional central banks were thus not kept "at home" but were sent to New York for investment in bankers' acceptances.¹⁸ In this way the central banking reserves of the interior Reserve banks percolated into the stock market via the bank acceptance route.

The abnormally low Federal Reserve buying rates and lax policy regarding the quality of acceptances placed quantities of central reserve credit at the disposal of the New York banks. This made it possible for those banks to loan many times such amounts of central reserve credit in the stock market. Security speculation was stimulated resulting in a rise in the call loan rate which in turn further attracted

¹⁶ Since 1924 there has been a high degree of uniformity of acceptance rates at the Federal Reserve banks. See *The New York Money Market*, Vol. III, pp. 442-444.

¹⁷ *Hearings on Banking Systems*, 1931, p. 778.

¹⁸ See *Annual Report of the Federal Reserve Board*, 1919, p. 6; *Federal Reserve Bulletin*, August, 1925, p. 527.

more funds to New York to be loaned on the stock exchange. Thus the management of the bankers' acceptance market tended to make the New York call loan market more important than it was before the Federal Reserve system.

The influence of the Federal Reserve Board and the Reserve banks, through their particular support of the bankers' acceptance market, worked against the development of the commercial paper market. The low acceptance rates and buying policy together with the use of domestic acceptances¹⁹ tended to result in financing by means of acceptances rather than commercial paper. Furthermore, the abundance of bank credit created and supplied for stock speculation at low cost stimulated the financing of trade by security issues instead of by commercial paper loans. Well-known companies which previously had obtained working capital through the sale of their promissory notes in the commercial paper market replaced this type of financing with the sale of securities. As a result the volume of commercial paper distributed through the market has been largely reduced.²⁰

The paternalistic support accorded the bankers' acceptance market by low buying rates and the other means mentioned, while necessary in the beginning, was too long continued by the Reserve banks to permit the establishment of a sound acceptance market to date. A real acceptance market, one not primarily inherent in the Federal Reserve banks, has been prevented by the central bank policy.²¹ The influence of the low acceptance buying rates was to cause the demand for acceptances to come chiefly from the Reserve banks. At the same time the low rates had the correlative effect of increasing directly and indirectly the relative profitableness of call loans. American banks usually

¹⁹ The original Federal Reserve Act did not authorize domestic acceptance credits. For a discussion of the reasons for not authorizing them, see Beckhart, *The New York Money Market*, Vol. III, pp. 261-264. Acceptance privileges were extended to domestic transactions by the amendment of September 7, 1916, concerning which see the same volume, pp. 267-269.

²⁰ Hearings on Banking Systems, 1931, p. 862.

²¹ Cf. in general, Beckhart, *The New York Money Market*, Vol. III, chapter XIII.

found the yield so low as to warrant not investing their funds in acceptances.

The Federal Reserve system has, however, brought about the establishment of an incipient discount market on a national scale, centering in New York City. In a few cities of financial importance, particularly Boston, Chicago, and San Francisco, there has been a limited development of local markets. But, on the whole, the establishment of local discount markets has been retarded.²²

Under our central banking system, in any time of crucial strain involving a widespread withdrawal of bank balances or brokers' loans, the New York banks have always been able to meet the situation.²³ The "Wall Street" banks have, throughout the existence of the Federal Reserve system, returned "cash" to their correspondents and other lenders in the call money market whenever requested. These New York banks have been able to get the "cash" because of the presence of the Federal Reserve Bank "around the corner." But the banks did not have to hold bona fide commercial paper such as the Federal Reserve Act made the basis for tapping central bank resources.

When American banks and the "others" called their brokers' loans, the New York banks borrowed from the Reserve Bank on government securities or were relieved by the Bank's purchase of "governments" and acceptances in the open market. It was chiefly by these methods that the New York Reserve Bank rendered the call loans from all over the country liquid at times of emergency. By reason of the existence of the Federal Reserve system, therefore, there has been a lender of last resort in the New York money market which has provided an elasticity to bank credit, a liquidity to call loans, not possible under the old national

²² For a variety of economic and technical reasons for the centralization of the acceptance business and the lack of establishment of local discount markets, see *Hearings on Banking Systems*, 1931, pp. 849-852. See also *The New York Money Market*, Vol. III, pp. 330-346.

Cf. in general, *Facts and Figures Relating to the American Money Market*, American Acceptance Council, 1931.

²³ The period of the Bank Holiday, by Executive Order of the President, may be considered in a sense an exception. See p. 405.

banking system. The activities of the New York Reserve Bank in counteracting influences in the money market and stabilizing short-time credit conditions have resulted in making call loan rates more stable than before 1914. Hence banks have been more certain of a satisfactory return on their placements in call loans.

The facilities of the Federal Reserve system, then, made call loans more attractive than before its establishment. These loans not only still offered a return on available and idle funds but much of the time the highest returns as between alternate uses. Moreover, under the Reserve system, call loans possessed the added allurements that they were safer and more liquid.²⁴ Consequently American banks tended to put their secondary reserves in the New York call money market rather than into bankers' acceptances or commercial paper.

Relation of Reserve Banks to the Stock Market

It was not the function of our central banks to regulate trading on the stock exchanges. Their duty was to prevent the ultimate reserves of the commercial banking system from going into speculative and investment channels. Moreover, there was reason for the Federal Reserve authorities to take cognizance of the use made of the member banks' own resources in determining central bank rate, open market, and loan policies. This is because the large amount of bank credit used in financing security trading influenced both directly and indirectly industrial, agricultural, and commercial conditions.

We shall here review the contact which the Federal Reserve system has had with the stock market. The Reserve banks in the larger cities, particularly New York, have more or less aided and abetted trading in securities. Their opera-

²⁴ The liquidity referred to is from the point of view of the interior banks and the "others." The stock-exchange call loans have not been liquid per se. The reason for this is that they were shifted about in the market among different lenders, under the stimulus of credit expansions, rather than being liquidated by the passage of securities to the ultimate investor. Their immediate and apparent liquidity was in reality derived from dependence on the Federal Reserve system.

tions have mainly had to do with supplying the required funds and adjusting rates whenever the stock market situation seemed to require or permit.

Loan rates in the call money market are fixed by the supply of and demand for such funds. The rates are not fixed, however, by the forces of free competition but are controlled. The supply of money loaned at the "money desk" of the New York Stock Exchange has been controlled by those chiefly interested in loaning bank credit. The money committee of the New York Stock Exchange has on various occasions advised the administration of the New York Reserve Bank of "the state of the money situation, and what they think the rate ought to be."²⁵ The officials of that Reserve Bank have collaborated with the money committee of the New York Stock Exchange in determining the rate on call loans.²⁶

The method of the New York Reserve Bank in giving effect to this collaboration has been to furnish any funds needed in order to enable the "money crowd" to make its loans and the banks to adjust their reserve position.²⁷ It has been common practice for the "Wall Street" banks to borrow from the New York Reserve Bank for the purpose of regulating the call loan rate.²⁸ This was done with the knowledge of the board of directors of the Reserve Bank. A result of the Federal Reserve system has been that, through the coöperation of the New York Reserve Bank with the stock exchange authorities, it has tended to stabilize call loan rates. Although such rates have occasionally reached high levels, these have never compared to the heights which they attained during the pre-Federal Reserve period.²⁹ At the same time, however, the New York Reserve

²⁵ Hearings on Banking Systems, 1931, p. 95.

²⁶ Hearings on Banking Systems, 1931, p. 26; Stabilization Hearings on H. R. 7895, 1926, pp. 355-356. Concerning the technique of fixing call loan rates, see *The New York Money Market*, Vol. III, chapter II, by B. H. Beckhart.

²⁷ Stabilization Hearings on H. R. 7895, 1926, pp. 355-356.

²⁸ Hearings on Banking Systems, 1931, p. 95.

²⁹ The success of the use of Federal Reserve credit in the stock market so far as lowering and stabilizing the call loan rate is concerned, is evidenced by a comparison between the call loan rates before 1914 and those since the establishment of the Federal Reserve system. Some of the very high call loan rates

Bank has been operated in such a manner as to enlarge and maintain brokers' loans at an inflated figure.

While the stabilization of short-time rates in the money market is commendable, the stabilization of call loan rates is secondary in importance for economic welfare to the prevention of inflation in the stock market. If it is a case of not stabilizing call rates by means of Federal Reserve credit or of supplying Federal Reserve credit which would enable speculation to inflate the prices of securities to ever higher levels, call rates had better not be stabilized. For, if as a result of the lack of stabilization the check to security inflation comes sooner than otherwise, inflation does not proceed so far; the reaction to more reasonable prices is not so great; and therefore the subsequent losses and damage to the community are not so severe.

Stock market speculation and inflation in securities during the "new era" resulted from an easy money policy initiated by the New York Reserve Bank which made money abundant and cheap in the national security market.³⁰ As a result of all the ways by which the reserve requirements were lowered or actual reserves relative to existing deposits were increased, it was possible to create the expansive superstructure of bank credit used in security speculation.³¹

prior to 1914 were the following: 1890, 186 per cent; 1892, 40 per cent; 1893, 74 per cent; 1895, 100 per cent; 1896, 127 per cent; 1899, 186 per cent; 1901, 75 per cent; 1905, 125 per cent; 1906, 60 per cent; 1907, 125 per cent. (Hearings in Agricultural Inquiry, 1921, p. 541.) Under the Federal Reserve system 30 per cent was the highest rate for call money and this rate prevailed for one day only. Moreover, call money rates have rarely gone over 10 per cent. These rates are on a per annum basis. (Consult also *The New York Money Market*, Vol. IV, pp. 511-518, by James G. Smith.)

³⁰ Stabilization Hearings on H. R. 11806, 1928, p. 189.

Numerous predictions and warnings that inflation and collapse would follow the Federal Reserve easy money policy of 1927 were expressed by Dr. H. Parker Willis. His forecasts of the resulting economic disaster were voiced not merely in 1929 when the security inflation was about to collapse but immediately upon the inauguration of the central bank policy in mid-year 1927. See *The Journal of Commerce* [New York], 1927, 1928, and 1929, editorial pages.

Dr. B. M. Anderson, Jr., in a treatise entitled: "Some Major Forces in the International Money Market," expressed disapproval of the 1927 credit policy. See *The Chase Economic Bulletin*, Oct. 29, 1927, pp. 24-25.

³¹ See chapter XVII, section on Reasons for Correspondent Banking and Concentration in New York.

Federal Reserve credit was used indirectly in the stock market as a result of two general Reserve bank operations, loans to member banks and open market purchases. The loans were made for the most part upon the member banks' promissory notes collateralized with government securities. By purchases of government securities and acceptances the Reserve banks placed more reserves at the disposal of member banks. This resulted whether the Reserve banks purchased from the member banks or from private bankers and dealers. Purchases from the private financial houses and non-member banks were paid for in "federal funds," deposited in the banks and redeposited in the member bank reserve accounts. Experience has shown that funds entering the market by the Reserve system's open market purchases went in the first instance into the stock exchange loan account.³²

Inasmuch as both the central money market and the national security market are located in New York City, particular responsibility for Federal Reserve policy devolved upon the Federal Reserve Bank of New York. Having stimulated security speculation in the first place by its easy money policy, the New York Reserve Bank did little if anything to restrain the use of central reserve credit for trading or carrying securities once this speculation gained momentum. On numerous occasions during the existence of the Federal Reserve system, New York member banks have borrowed from the Reserve Bank in order to keep from withdrawing stock exchange loans.

Whenever interior banks and the "others" called their brokers' loans, the New York Reserve Bank aided "Wall Street" banks in supporting the stock market.³³ In fact these member banks have had assurance that they could go to the New York Reserve Bank and get whatever funds were necessary to take care of the withdrawal of interior funds loaned on the stock exchange.³⁴ In addition, that

³² Stabilization Hearings on H. R. 11806, 1928, p. 362.

³³ See chapter XI, section on Emergencies. Consult also *The New York Money Market*, Vol. IV, chapter VIII, by B. H. Beckhart.

³⁴ Stabilization Hearings on H. R. 11806, 1928, p. 231.

Reserve Bank made loans to its member banks and substantial open market purchases at times when brokers' loans were rising.

Private financial houses and non-member banks were particularly aided by the policy of the Reserve Bank regarding the acceptance rate and the volume and quality of acceptances purchased. But non-member as well as member banks obtained the use of Federal Reserve credit in another way. This occurred as a result of borrowings from a Reserve bank by member banks which made payments to other banks which had loans on the stock exchange.

Accepting banks obtained some funds to loan in the stock market by carrying their customers on an acceptance basis, inasmuch as the New York Reserve Bank did not discriminate between speculative or "accommodation" acceptances and essentially liquid acceptances.³⁵ In the spring of 1929 the New York Journal of Commerce reported in an editorial the following:

According to practical bankers largely in the acceptance business, the precaution surrounding the making of acceptances has been much relaxed of late and during the past season perhaps 50 per cent of all acceptances were being made without very much regard to the liquidity or the character of the underlying transactions.³⁶

Furthermore, the practice of the New York Reserve Bank of buying no paper direct from business concerns and of buying acceptances only from financial houses which had not less than \$1,000,000 capital tended to lessen the commercial aspect of the Federal Reserve system and enhance its use to interests affiliated with the stock market.

Differential discount rates according to the character and duration of the paper, used in the early years of the Federal Reserve system, were soon discontinued and were not in use in the decade of the '20s. After putting the very low discount rates into effect, when the speculative fervor stimulated by the cheap money policy gained momentum, the New York Reserve Bank then delayed the raising of

³⁵ H. Parker Willis, *The Banker*, London, July, 1928, p. 22.

³⁶ *The Journal of Commerce* [New York], May 23, 1929.

rates until the inflationary movement was beyond control. Moreover, that Reserve Bank did not decline to rediscount eligible paper when an applying member bank had loans on the stock exchange. And finally, the efforts of the Federal Reserve Board to get the New York Reserve Bank to apply a method of persuasion to the "Wall Street" banks did not elicit the coöperation of that Reserve Bank.³⁷

The depression of the early '30s was due in no small degree to the orgy of speculation and inflation in the stock market which preceded it. The enormous expansion of bank credit used in security trading went hand in hand with successive levels of higher stock prices, paper profits, and the enlargement of production capacity and output. The ensuing stock market collapse resulted in a loss to the community which was estimated at \$58,000,000,000.³⁸ When stock prices fell, the purchaser of stocks with bank credit could not liquidate his loan at a profit by the resale of the stock in the market. Consequently he was obliged to save to pay off his bank or broker's loan.

This effort to pay for stocks whose inflated market value had vanished meant that the purchasers could not continue to spend as they had for goods. The debts of those who held inflated stocks when the crash came in October, 1929, curtailed purchasing power enormously. The demand for goods fell off throwing employees out of work. The reduction of purchasing power then was accelerated by the resulting unemployment. Thus the pressure to liquidate loans based on the inflated security prices helped bring on business stagnation and intensified the depression. In so far as the depression was due to this train of events, the Federal Reserve banks, and particularly the New York Bank, contributed much to its severity, inasmuch as by their policies they stimulated the security inflation and over-expansion in certain industries.

Although the establishment of our central banking system

³⁷ See chapter XIII, section on Conflict between the New York Reserve Bank and the Federal Board.

³⁸ Some estimates ran even higher than that figure. Hearings on Branch, Chain, and Group Banking, 1930, p. 726.

had been intended to reduce the use of bank credit in the stock market, it has not done so. Moreover, the expectations which had been practically universally entertained at the time Congress passed the Federal Reserve Act, that no part of the central bank reserves would get into not merely the so-called "speculative" loans but even security loans, have not been realized. The operation of the Reserve banks, controlled by directors elected by the member banks whom they served, resulted in supplying at low cost abundant central reserve credit for speculation and "carrying" securities.

While member banks have not been able to turn stock exchange securities over to a Reserve bank and thus replenish their legal reserves and extend more credit to the stock market, such being illegal, they have secured these reserves by other means. The practice of sending interior Reserve bank funds to New York for investment in acceptances worked hand in hand with the practice of loaning to member banks on their security-collateralized notes in furnishing funds for the stock market. In supplying banks with central reserve credit virtually in exchange for government securities, the Reserve banks did not analyze the financial statements of business concerns. The expansion of bank credit went on apace practically unrestrained by the checks of central banking controls.

Member banks obtained quantities of legal reserves with ease without placing upon the central bank the obligation of testing commercial credit. In the banking process these reserves were multiplied many times. The superstructure of credit was enlarged, resulting in rampant security speculation and over-expansion in industry. Credit money does not grow nor create itself. Some one must create it and push it along. This was done by those who controlled it, the bankers, under the impetus of the profit motive.

Instead, then, of devoting central reserve credit solely to the uses of commercial banking, it was used indirectly in financing trading on the stock exchange. Such use, as previously pointed out, has been contrary to the intent and spirit of the Federal Reserve Act.³⁹ The Federal Reserve

³⁹ The intended commercial banking character of the Federal Reserve sys-

system has been an adjunct of the investment banking and speculative finance interests. So close and extensive has this affiliation been that the maintenance of genuine liquidity of Federal Reserve assets has been submerged. The American central banking organization has been to a considerable degree an investment banking system.

The Federal Reserve Bank of New York as a Central Bank

In adopting the Federal Reserve plan of having a chain of central banks instead of one central bank for the United States, Congress sought to diminish the power of the New York banking group relative to the rest of the banking organization. It purposed to avoid the creation of a central banking system wherein one Reserve bank would be preponderantly larger than any of the others. There was to be more or less equality among the various Reserve banks. Consequently the districting of the United States was carried out in such a way as to lessen the relative size and influence of the Federal Reserve Bank of New York. Territory thought by some to belong to New York was allocated to other districts. The geographical area attached to the New York Bank was confined to the State of New York and eleven counties in two adjacent states.⁴⁰

Although legally constituted as a district or regional central bank, so far as the Reserve banks are concerned the New York Bank has exerted the chief influence upon American banking and economic conditions and our international relationships. A major reason for the country-wide scope of its influence has been the continuation of the correspondent

tem was recognized by a governor of one of the Reserve banks. George W. Norris, governor of the Federal Reserve Bank of Philadelphia, gave a talk before the monthly luncheon of the Philadelphia Association of Security Salesmen in February, 1930. In discussing the October, 1929 stock market panic, he pointed out to the salesmen the connection of the Federal Reserve system with the capital market at that time. Mr. Norris said that "the Federal Reserve Bank of New York stepped in and within twenty-four hours bought \$150,000,000 of government bonds and in other ways gave assistance. It was courageous action and you received a benefit from the Federal Reserve system that it was not intended you should have." The New York Evening Post, Feb. 20, 1930.

⁴⁰ See chapter III.

banking system. Whereas member banks were related to the Reserve banks of their respective districts, such relationship did not preclude affiliations with banks in the financial centers. Thousands of banks located in all the Federal Reserve districts, member as well as non-member, have continued to deal with the New York City banks. Indeed, the correspondent banking relations of the New York banks became more extensive and national in scope during the existence of the Federal Reserve system than before its establishment.

The Federal Reserve system has helped to maintain and make more efficient the correspondent banking relationships. On occasion excess balances of out-of-town banks have piled up in the New York member banks which in turn resulted in surplus balances at the Reserve Bank. The New York Reserve Bank has indeed looked upon these balances as being actually owned by banks in other Federal Reserve districts.⁴¹ At other times the New York Reserve Bank has extended any credit required on account of the withdrawal of brokers' loans or deposits from the interior, and, furthermore, has supported the New York banks in their loans to banks in all Federal Reserve districts. The balances which correspondent banks have kept on deposit in the New York banks have been considerably larger than the reserve deposits kept by the New York banks with the Federal Reserve Bank. Consequently even relatively moderate withdrawals of funds by outside correspondents have frequently resulted in borrowing by the New York banks from their Reserve Bank.

During particularly the two major depressions under the Federal Reserve system, the New York Reserve Bank worked in close cooperation in furnishing central bank credit to the New York City banks which were lending to banks and others in all Federal Reserve districts. During the post-war depression (1920-1922) the interior bank clients of the New York banks felt the pressure of their district Reserve banks, paid off their loans with them, and transferred those

⁴¹ See Federal Reserve Bank of New York, *Monthly Review of Credit and Business Conditions*, March 1, 1933, p. 1.

loans to their New York correspondents, in some cases using the same collateral which they had pledged with the Federal Reserve banks.⁴² Consequently the burden of supporting such loans was transferred from the interior Reserve banks to the Federal Reserve Bank of New York through the medium of the New York correspondent banks. The loans, during this depression of the early '20s, by six of the largest New York City banks to out-of-town correspondent banks were larger than they had previously been, even before the establishment of the Reserve system.⁴³ As a result the borrowings from the New York Reserve Bank were especially heavy.⁴⁴

Again, during the depression of the early '30s the New York Reserve Bank gave constant support to the entire banking structure of the country by coming to the aid of its city member banks whenever necessary.⁴⁵ The governor of the Reserve Bank held conferences with the heads of the "Wall Street" banks at which the question of a more liberal credit policy on the part of the New York banks toward correspondent banks throughout the country was considered.⁴⁶ It was announced that "all deserving" interior banks were being taken care of by the New York Clearing House banks under the aggressive direction of the governor of the Federal Reserve Bank.⁴⁷

In line with the purpose of Congress to prevent the concentration of financial power by establishing the regional

⁴² Hearings in the Agricultural Inquiry, 1921, Part 13, p. 648. See also these hearings, pp. 637-649.

⁴³ *Ibid.*, p. 641.

⁴⁴ The loans made by New York City banks, as of November 15, 1920, to banks, railroads, public service corporations, and others outside of the Second Federal Reserve District totaled \$1,375,276,750; and their total borrowings from the Federal Reserve Bank were \$880,640,000. Hearings in the Agricultural Inquiry, 1921, Part 13, p. 641.

On February 14, 1921, the loans to banks, railroads, and corporations outside of New York State by the five New York City banks which were then the largest borrowers at the Federal Reserve Bank, were \$280,000,000 more than their borrowings at the Reserve Bank. Hearings in the Agricultural Inquiry, 1921, Part 13, p. 641.

⁴⁵ See chapter XI, pp. 223-231.

⁴⁶ The Commercial and Financial Chronicle, Oct. 17, 1931, p. 2550; The New York Times, "Topics in Wall Street," Oct. 17, 1931.

⁴⁷ The Commercial and Financial Chronicle, Oct. 17, 1931, p. 2550.

central bank plan twenty years ago, just before the Federal Reserve banks were opened, Woodrow Wilson said:⁴⁸

No group of bankers anywhere can get control. No one part of the country can concentrate the advantage and conveniences of the system upon itself for its own selfish advantage. . . . I think we are justified in speaking of this as democracy of credit.

However, as conditions have developed under the regional central banks, it appears that New York banking interests largely control the situation in much the same way as they did before the Federal Reserve era. The head of the largest bank in New York, with thousands of correspondent banks in all Federal Reserve districts, reported that the Chase National Bank would not extend credit to a correspondent bank unless its statement was about what was wanted.⁴⁹

The experience of a mid-western banker bears out the testimony of this New York banker. A banker in Cedar Rapids, Iowa,⁵⁰ who had \$3,000,000 of deposits in his bank told (in August, 1927) of his subserviency to New York in a statement reported as follows:⁵¹

At this moment I have \$1,600,000 of that in New York. Part of that is in bank balances and I am getting $1\frac{3}{4}$ per cent. Part of it is invested in listed bonds, for which I am getting $4\frac{1}{4}$ per cent, charging my farmer neighbor 7 per cent, and charging the best business loans 6 per cent. I am doing that under this system because if I lend money to a farmer and he does not pay when it is due, and we lose it or put it on the slow list, it is no longer rediscountable, and I am under suspicion, and in order to keep myself in good standing according to the New York rules, I am forced to run my bank that way.

It was reported that this situation as depicted by the Cedar Rapids banker was typical of banks in other cities in Iowa and was general throughout the state.⁵² Again, a pro-

⁴⁸ This statement is attributed to Wilson in a letter to Representative Underwood. Quoted by Pierre Jay, former chairman of the Federal Reserve Bank of New York, in *Trust Companies Magazine*, March, 1926, p. 348.

⁴⁹ Testimony of Albert H. Wiggin. Hearings on Banking Systems, 1931, p. 186.

⁵⁰ Located in the Seventh (Chicago) Federal Reserve District.

⁵¹ Hearings on Brokers' Loans, 1928, p. 56.

⁵² *Idem*.

fessor in a state university of the Middle West ⁵³ gave further evidence of the control exercised by the New York bankers over the interior banks. He stated that the country banker of Wisconsin put it in this way: ⁵⁴

We get our orders from New York. Either we are in a squeeze and tighten up or in a position where we have to loosen up. If we tighten up or loosen up we get orders from New York.

Following the investigation in 1931 by the Senate Banking and Currency Committee of the operation of the Federal Reserve system, Senator Carter Glass declared that the interior banks were practically forced under the guise of "advice" to take billions of dollars of low-grade foreign securities.⁵⁵ The senator said that he had heard banker after banker say that they had purchased certain investment securities from the big city banks "not because they wanted them, not because they were confident that they would be remunerative or that the facilities of their respective banks would justify their purchase, but because they were indebted to the offering banks for accommodations extended." ⁵⁶

On account of the subservience of the interior correspondent banks, then, to the "Wall Street" banks, the New York Reserve Bank has been related to member and non-member banks in all Federal Reserve districts. That Reserve Bank has been in fact the lender of last resort to thousands of banks throughout the country. Its credit policy has vitally affected conditions in their communities. Consequently the Federal Reserve Bank of New York has possessed special significance as a national central bank.

The Federal Reserve Bank of New York has also served in the capacity of a central bank for the country inasmuch as its member banks have to an increasing degree financed American industry and trade. Comparatively speaking, before 1914, business concerns in the towns and cities dotting the country satisfied their banking requirements from their

⁵³ John R. Commons, University of Wisconsin.

⁵⁴ Stabilization Hearings on H. R. 7895, 1926, p. 1108.

⁵⁵ Congressional Record (unbound edition), May 10, 1932, p. 10196.

⁵⁶ *Ibid.*, p. 10204.

local banks. Since the establishment of the Federal Reserve system, far reaching changes in business organization and finance have taken place.

In view of the lack of branch banking and the extent to which the combination movement has been carried, business concerns have not been able to obtain satisfactory accommodation from local banks.⁵⁷ Consequently companies have tended to go to the large money centers in order to satisfy their credit needs. Many corporations which formerly had their head offices elsewhere have grown so large or have become units of holding companies, with the result that they have found it desirable to establish their financial headquarters in New York City.⁵⁸ Whether they did their financing by means of bank loans or by issuing securities, they have been served by the large New York banks, and hence the New York Reserve Bank.

Moreover, the New York Reserve Bank has served the nation's business in another way. Whereas commercial banks in other Federal Reserve districts made loans to companies situated in their own communities, the "Wall Street" banks have business customers in every state in the Union. These New York banks have made loans not only to local companies but to railroads, public utilities, life insurance companies, industrial and commercial corporations, throughout the country.⁵⁹

⁵⁷ *Ibid.*, p. 10206; Hearings on Branch, Chain, and Group Banking, 1930, p. 1566; Hearings on Banking System, 1931, p. 217.

The National Bank Act has prohibited bank loans to one business concern or customer of more than 10 per cent of its capital and surplus.

⁵⁸ See Stabilization Hearings on H. R. 7895, 1926, p. 1006; Hearings on Branch, Chain, and Group Banking, 1930, pp. 1210-1214, 1322-1323; Annual Report of the Federal Reserve Bank of New York, 1924, pp. 17-18.

⁵⁹ Hearings in the Agricultural Inquiry, 1921, pp. 637-641, 648-649; Hearings on Branch, Chain, and Group Banking, 1930, p. 1566; Hearings on Banking Systems, 1931, p. 217.

In the fall of 1920, the borrowings of the New York banks from the Federal Reserve Bank had increased enormously. In response to an inquiry from the Federal Reserve Board as to the reason for such increase, the Reserve Bank gave as one of the reasons the refusal of southern banks to handle cotton paper. The Reserve Bank said: "In the case of Bank C additional funds have been required to assist in the financing of cotton. The depression in the cotton trade has caused many local banks to refuse to deal in cotton paper and the big New York City banks, in consequence, have had to shoulder the burden."

Hand in hand with the increase in the size of the business organization and the meeting of its financial requirements through the New York market has been the sending of funds of local units of the combinations to New York and other centers. Thus in analyzing the situation in Dayton, Ohio, during the recent depression, ex-Governor Cox of Ohio, as head of a city committee, found that the "major disorder" common to all cities was "the sequence of a new economic order." Governor Cox reported as follows:⁶⁰

In the last twenty years the chain stores and the chain theatres have developed, and there has been an intense centralization in industry. Most of the chain stores and theatres deposit their balances locally every day, and then immediately check them out to large banks, principally in New York. . . . It is a slow process of strangulation. New York in the last two or three years has had so much money that it doesn't know what to do with it.

This analysis of the situation was accepted as representing an accurate portrayal of conditions by New York bankers in conference with representatives of the Dayton committee.⁶¹ It is further indicative of the extent to which New York City has become a national financial center through which the New York Reserve Bank's policies affect the nation.

All the sub-divisions of the national money market—the market for federal funds, call loan money market, discount market, commercial paper market, government bond market, and the general securities market, center in New York City. There has been a constant ebb and flow of funds between New York and other parts of the country. There is some movement of funds between other money markets, Boston, Chicago, Cleveland, San Francisco, St. Louis, Minneapolis, etc. But there has been a movement of funds between New York and all other money markets.⁶² More-

⁶⁰ The New York Times, Oct. 16, 1931, editorial page.

⁶¹ *Idem.*

⁶² Such movements have taken place with more or less regular recurrence. There are weekly, monthly, quarterly, and seasonal movements. See *The New York Money Market*, Vol. IV, Part III, by James G. Smith; *Annual Report of the Federal Reserve Bank of New York*, 1924, pp. 16-21; *Stabilization Hearings on H. R. 7895*, 1926, pp. 443-449, 453-455, 969; *Hearings on Banking Systems*, 1931, p. 86.

over, an operation in another market affected the "nerve center" in New York City. There the stimulus was "offset" by the New York Reserve Bank or allowed to work itself out. In either case the result was promptly reflected more or less throughout the country.

The New York money market has come to be more national in scope than it was before the establishment of the Federal Reserve system. Being the central bank for all the sub-divisions of the national money market, the New York Reserve Bank has been in a position to influence the general credit situation of the United States either by stimulating or restraining that market. Concerning the movement of funds between New York and other money markets and the national aspects of the credit policy of the New York Reserve Bank, Mr. Strong, governor of the Bank, commented as follows: ⁶³

The operation of the New York Bank in these respects, that is, looking at the whole volume of credit, has to be conducted with a close eye to our own position in our local market and *equally with consideration to the position of the whole system*. We could not tell, because of this vast flow of credit that takes place throughout the country, what to do in New York unless we knew what was happening *in every other district*.⁶⁴

The New York Reserve Bank, then, has dealt with national credit in the mass. Its discount rate policy has affected a considerable volume of business of national companies whose financing was handled in the New York market, as well as the banking structure of the country and hence other business which has tied up with that Reserve Bank through the New York correspondent banks. Since Reserve system open market operations were centralized in the New York Bank, it practically determined whatever influence such operations had on the national economy. The credit policy of the New York Reserve Bank, therefore, has had a substantial influence on financial and business conditions in all Federal Reserve districts, which influence

⁶³ Stabilization Hearings on H. R. 7895, 1926, p. 455.

⁶⁴ The italics are the author's.

no other Reserve bank has held. This power of the New York Bank has been recognized many times during the development of the Reserve system, when Federal Reserve authorities have sought to change general business conditions by initiating a change in the discount rate and/or open market policy of that Reserve Bank.

In addition to its national importance, the New York money market has been the international money market of the United States. It has been the principal financial center of the western hemisphere. The Canadian banks especially have made constant use of the New York money market. The contact between Montreal and New York has been almost as close and intimate as between Chicago and New York. So close has been the relationship of the banks of our northern neighbor to the American money market that there was serious consideration on both sides of the border of admitting the Canadian banks to membership in the Federal Reserve system.⁶⁵ Following the shift of the United States during the war from a debtor to a creditor nation, the power of this country in international finance assumed commanding importance. New York became one of the leading financial centers of the world and London vied with it for the premier position.

During the decade of the '20s New York was in some respects the leading money market of the world. Foreign commercial banks and corporations sent funds to New York and foreign central banks placed some of their reserves and surplus funds in that financial center. These foreign short-term funds sent for deposit and investment reached unprecedented sums. There was a constant demand for and supply of exchange on New York in all parts of the world. The New York market had the largest fund of gold available for banking operations; it did the largest amount of international lending; it performed the functions of a free gold market; and upon it rested the major burden of supporting the gold exchange standard of many nations. Currencies which were on the gold or gold exchange standard

⁶⁵ Canada would thus become practically the thirteenth Federal Reserve district.

were adjusted to the American dollar, which became the chief arbiter of international prices.

On account of the interdependence among nations, in carrying out the functions of central banks of modern times, coöperation with other central banks developed. The central banks became the liaison offices of the banking systems of the various countries. In this international collaboration of central banks, the foreign policy of the Federal Reserve system was centralized in the New York Reserve Bank. In so far as the gold standard was managed in this country, it was essentially done by that Reserve Bank. Furthermore, the New York Reserve Bank has been the American central bank in foreign exchange and in making commitments abroad involving all of the Federal Reserve banks.

CHAPTER XIX

TWENTY YEARS OF THE FEDERAL RESERVE SYSTEM

During the twenty years in which the Federal Reserve system has been in operation, its major influence on our national economy has, of course, been exerted through its credit policy. Federal Reserve credit policy during this period has been the composite result of several conflicting interests. The effort of the Reserve Bank Organization Committee to avoid the establishment of a Reserve bank in New York which would be preponderant in size and importance as compared to any of the other Reserve banks was not successful. The Federal Reserve Bank of New York has been so large and has possessed such power and influence that none of the other regional central banks has been at all comparable to the New York Bank in these respects.

So overwhelming has been the power of the New York Reserve Bank, that the instrumentalities through which Federal Reserve credit policy has been expressed may be brought into a grouping of three—the Federal Reserve Board, the Federal Reserve Bank of New York, and the other, or interior, Federal Reserve banks. At times the Federal Board has held the balance of power in the system and at other times the New York Reserve Bank. But the influence of the interior Reserve banks has always been weak.¹ On the whole there is reason to believe that the Federal Reserve Bank of New York has been the dominant

¹ The replies of the Federal Reserve banks to the questionnaire submitted by the Senate Committee on Banking and Currency in 1931 disclosed that some of the interior Reserve banks disagreed with the system open market policy. If the interior Reserve banks had had more influence in determining the open market policy, the economic distress experienced during the recent depression would probably have been less severe, inasmuch as some part may be traced to the open market purchases. (See Hearings on Banking Systems, 1931, Part VI, Questionnaires No. 9 and No. 10.)

instrumentality which has controlled the credit policy of our central banking system.

The Federal Reserve Bank of New York has been preponderant in size as compared to any of the regional central banks. It has generally held about one-third of the total central reserves of the system, while its deposits have reached even a higher percentage, these being at times about one-half of the deposits of all the Reserve banks combined. But the relative influence of the New York Bank in the system has been far greater than its proportionate size. Confined as it was to a small geographical area,² it has been much more than a Reserve bank for the Second Federal Reserve District.

The chief reason for this is that the New York Reserve Bank is located at the central money market. In affecting all the sub-divisions of the national money market its operations have affected the entire United States. As a result of the functioning of the commercial and financial organization, funds were drawn to New York from all districts. This was accomplished through the medium of the regular transactions in various money markets, the correspondent banking system, and the open market operations.³ Through the medium of its local member banks, New York Reserve Bank credit has found its way to all Federal Reserve districts. Given its strategic location and the influence of the New York Reserve Bank's operations in the money market, the fact that its resources were so much larger than those of any other Reserve bank made its power all the greater and the extent of its dominance all the more evident.

The Federal Reserve Bank of New York has been in some respects a central bank for the larger proportion of the com-

² The State of New York, one county in Connecticut, and ten counties in New Jersey.

³ Open market operations were centralized in the Federal Reserve Bank of New York. When acceptances appear among the assets of the individual Federal Reserve banks, that does not mean that the Federal Reserve credit thus released is available for the customers of the banks in their respective districts. On the contrary that credit is largely lodged in New York. The interior Reserve banks sent their funds to New York for investment in acceptances and securities. The funds so released became a part of the credit in the New York money market which the "Wall Street" banks made available at their discretion to their correspondent banks throughout the country.

mercial banks (particularly the non-member) of the country. It has been the central bank for the stock market and the various money markets. It has been the central bank in the regulation of foreign exchange, and in the management of the gold standard. In the exercise of the central banking function of credit control, the New York Bank's policies have possessed the chief influence on our national economy. The Bank has been the chief fiscal agent of the United States. Treasury operations have largely been centralized in that Bank, which has then effected distributing relationships with the other Reserve banks. Finally, the New York Bank has been the institution which has wielded the power in the foreign relationships of the central banking system, practically supplanting the Federal Reserve Board in this authority. Although the Federal Reserve Bank of New York is not the central bank of the United States, it has to a considerable degree served in the capacity of a national central bank.

We have seen that during the development of central banking under the Federal Reserve system a number of important achievements have been realized. Considerable progress has been made in the integration of the nation's banks. The centralization of reserves in the Federal Reserve banks and the coördination of the system under the Federal Board have done much to bring together the independent unit banks in a common service to the community. By the concentration of bank reserves their ready elasticity was effected, the old inelasticity of currency was abrogated, and there resulted a mobility of bank credit, making it more available to all parts of the country at any time. This united strength of the banking organization has been brought to the aid of individual communities and particular sections in time of emergency.

The centralization of gold effected a great economy in its use and aided substantially in a more efficient operation of the gold standard. The gold base of the banking system was brought under control so that the use of gold in the settlement of domestic or international balances was obtained without injury to other parties and without sub-

jecting the entire banking organization of the country to a breakdown. Moreover, on occasion, the Federal Reserve system brought an effective influence to bear upon gold movements. A complete control over gold movements in the face of more powerful forces has not been realized. Furthermore, our central banking system has enabled the United States to present a unified banking front to foreign countries for the first time in its history.

A beginning has been made in developing a national discount market. Through the use of the acceptance powers and the purchases by the Reserve banks, the financing of America's foreign trade has been accomplished at less cost than formerly and on otherwise more favorable terms. Unfortunately, however, serious abuses have been so common in the use of the bankers' acceptance as to leave much room for improvement in this type of financing. The effort to develop genuine local discount markets about each Reserve bank has been retarded, although there has been some progress toward the establishment of money markets in a few other financial centers. The New York market during this twenty-year period became not only a real international money market but one of commanding importance in foreign affairs.

By the elimination of the Independent Treasury system and placing the numerous functions of the sub-treasuries in the hands of the Reserve banks, a desirable integration of public finance with the banking system was accomplished. Not only was a remarkable record made by the Federal Reserve system in financing our participation in the World War, but the collection and disbursement of government revenue have been carried on with an economy and efficiency far superior to conditions during the régime of the Independent Treasury. Although the Federal Reserve system has greatly facilitated the work of the Treasury in serving as its fiscal agency, on the other hand the system's subservience to the exigencies of Treasury finance has resulted in a changed condition of the assets of American banks. The portfolios of both commercial and Reserve banks became waterlogged with government securities.

The movement of funds to and from the various money markets and the operations of the Treasury in time of peace and war have been handled and "offset" so as to prevent serious short-time disturbances in the credit system. The extreme fluctuation in interest rates as a result of such movements, particularly in the financial centers, has been eliminated by "accommodation" from the Federal Reserve banks. The operation of the central banking system has resulted in a general lowering of interest charges and credit has been supplied at more uniform rates to all sections of the country than was the case in the pre-Federal Reserve era.

The Federal Reserve system has achieved important results in its clearing and collection functions. A national clearance system through the Gold Settlement Fund has been in successful operation. The benefits accruing from the system have been that the shipments of gold to and fro were avoided; there is a wider acceptability of checks, and faster and cheaper collection; and the "float" has largely been eliminated. The bulk of checks pass at par. The par clearance plan together with the Federal Reserve telegraphic transfer system have relieved the business public of the former heavy burden of exchange charges. Furthermore, by carrying on the clearance function the administrators of the Reserve system have obtained information useful in the shaping of their credit policies.

The extent of Federal Reserve membership is not indicative of the benefits accruing to American banking inasmuch as non-member state banks have received nearly as much benefit as have member banks. Not one of the forty-eight state banking systems has had any reserve credit power of its own. The Federal Reserve banks have comprised the only credit reservoir of the country. All the state banks have depended ultimately upon the Federal Reserve system and have looked to it to provide additional credit. The contact of the non-member state banks with the Reserve system has been chiefly through their correspondent banks in the financial centers. In addition the non-members have profited by (1) the discount market involving Reserve bank

purchase of the acceptances of state banks, (2) the rediscount, during the war financing period, of promissory notes with member bank endorsement, and (3) the clearing and collection services.⁴ Furthermore, in so far as the banking structure was strengthened and general credit conditions were made more stable by the Reserve system, the non-member state banks have derived a benefit as part of the milieu in which they operated.

The most disappointing results, perhaps, of banking under the Federal Reserve system are to be found in the record of bank failures. There were failures in thousands of communities throughout the country in spite of the Federal Reserve banks. In many cases all the banks in a town or city closed leaving the people without banking facilities or compelling them to resort to banking by mail. Indeed the twenty years of the Federal Reserve system witnessed a period of bank failures without parallel.

Bank failures began to increase during the latter part of 1920 and from 1921 assumed alarming proportions. During the years 1921-1932 over 10,000 national and state banks with deposits of nearly \$5,000,000,000 failed.⁵ The failures during this twelve-year period represented about 36 per cent of the total number of active national and state banks in

⁴ Although a substantial proportion (comprising mostly non-member but including some member banks) of the total number of banks have been using their city correspondent banks instead of the Federal Reserve banks as collection agencies, it has been due to the Federal Reserve system that the city banks have been able to render the quicker and more efficient collection service and at less cost than under the old national banking system.

⁵ Report by the Federal Reserve Committee on Branch, Group, and Chain Banking, volume on Bank Suspensions in the United States, 1892-1931. (In mimeograph form.)

For the purpose of the study by this Federal Reserve Committee, a bank was considered in suspension whenever its doors were closed to the public, either temporarily or permanently, by supervisory authorities or by the bank's board of directors on account of financial difficulties. Banks which were re-opened or taken over by other institutions after closing were included as suspensions.

Concerning the problem of bank failures, consult also Report of an Inquiry into Contemporary Banking in the United States, by H. Parker Willis and others, 7 volumes, 1925. Unpublished. (On file, Columbia University Library.)

The author uses the word failure as being synonymous with suspension in this treatise.

1920 and about 13 per cent of their total deposits at that time. In no previous period of equal length since the establishment of the national banking system in 1863 has so large a proportion of American banks failed. This was about five times the number which suspended during the previous twenty-nine years. The high mark was in 1931 when there was a total of 2,213 failures, or 10.5 per cent of all banks in operation in that year.⁶ The number of suspensions during each of the twelve years and the losses to depositors are shown in the following table:

TABLE 15
NATIONAL AND STATE BANK SUSPENSIONS
1921-1932 *

Year	Number	Gross Deposits
1921	461	\$ 163,299,000
1922	343	89,274,000
1923	623	146,347,000
1924	738	202,423,000
1925	579	159,904,000
1926	924	250,434,000
1927	636	194,992,000
1928	479	139,400,000
1929	628	222,931,000
1930	1,292	821,834,000
1931	2,213	1,669,075,000
1932	1,416	698,382,000
Total	10,332	4,758,295,000

* During the same period 476 private banks and 8 mutual savings banks failed. Trust companies and stock savings banks are included among the state banks. Bank Suspensions in the United States, 1892-1931, Table 1, by the Federal Reserve Committee on Branch, Group, and Chain Banking.

The percentage of state bank failures during the period was more than twice as high as that for national banks. The closing of the banks, involving as previously stated nearly \$5,000,000,000 of deposits, caused heavy losses to individuals, immobilized credits, forced liquidation, cur-

⁶ 10.5 per cent stands as the high mark, as far back as reliable records go, in the percentage of bank failures to active banks in a single year. In 1932 the proportion was also very high, the 1,416 failures accounting for 7.8 per cent of all banks.

tailed credit, and reduced purchasing power, which accentuated the severity of the recent depression.⁷

The high percentage of bank failures under the Federal Reserve system has, of course, not been due to the fact that there was not a central bank where bank assets could be converted into cash on demand to meet the claims of depositors, as was the case oftentimes under the old national banking system. A chain of central banks stood ready as lenders of last resort and were prepared to supply cash on the basis of eligible paper. But a fundamental difficulty was that so large a proportion of commercial banks did not have the liquid assets to offer the Federal Reserve banks. Their assets were "frozen" and it is no part of the function of central banks to accept anything but liquid paper.

The increase in member bank reserve balances during the decade of the '20s resulted in a deterioration in the quality of bank credit. The increase (actual and percentage) in the several classes of bank assets is shown in Table 16. "All other loans" were identified as mainly commercial loans.⁸ It is seen that this type of loan, which the Federal Reserve system was designed to foster, remained practically constant throughout the period, whereas loans on securities increased by more than 100 per cent and loans on urban real estate by over 200 per cent.

The proportion of commercial banking resources devoted to investments and security loans has increased since the establishment of the Federal Reserve system. The past decade, especially, witnessed a growing ratio of investment assets and a declining ratio of self-liquidating assets to demand liabilities. The principal asset of member banks as a group has been investments, including bonds, loans on stocks and bonds, and loans on real estate, instead of

⁷ According to estimates by the Comptroller of the Currency, in the nine years preceding 1930, 7,264,957 depositors contributed to the total of more than \$1,700,000,000 of deposits in failed banks and no less than 114,000 shareholders suffered losses through these suspensions. During these nine years, failed banks caused the enforced liquidation of approximately \$2,000,000,000 of loans, chiefly small loans. Hearings on Branch, Chain, and Group Banking, 1930, p. 14.

⁸ Hearings on Banking Systems, 1931, p. 137.

TABLE 16

LOANS AND INVESTMENTS, ALL MEMBER BANKS *

(In millions of dollars)

June 30	Investments	Loans on Securities	Loans on Urban Real Estate †	All Other Loans	Total Loans and Investments
1921	6,002	‡ 4,400	‡ 875	12,844	24,121
1922	7,017	‡ 4,500	‡ 1,100	11,565	24,182
1923	7,757	‡ 4,950	‡ 1,350	12,450	26,507
1924	7,963	‡ 5,350	‡ 1,575	12,279	27,167
1925	8,863	6,718	‡ 1,875	12,062	29,518
1926	9,123	7,321	2,161	12,579	31,184
1927	9,818	8,156	2,449	12,333	32,756
1928	10,758	9,068	2,624	12,611	35,061
1929	10,052	‡ 10,095	2,750	12,814	35,711
Actual Increase 1921-1929	4,050	5,695	1,875	§ 30	11,590
Percentage Increase 1921-1929	67%	129%	214%	—	48%

* Source: Hearings on Banking Systems, 1931, p. 138.

† Real estate loans other than farm lands.

‡ Partly estimated.

§ Decrease.

short-term paper.⁹ Inasmuch as the maturity of bank assets was not properly related to the demand claims of the depositors, banks were unable to pay money upon request and consequently failed.

Under the Federal Reserve system, prior to 1933, the general monetary stringencies of the type existing under the old national banking system were averted. The Bank Holiday of March, 1933, was more than a general panic. It constituted a complete collapse. But even during the anxious days preceding that episode the Federal Reserve system did not fail to meet the needs of that emergency. There is no reason to doubt that the Reserve banks met all legitimate demands for credit based upon eligible paper.

⁹ Other assets of the investment type included a portion of bankers' acceptances, and installment finance paper. The apportionment of bank credit to investment uses was shown in an extensive and detailed report submitted to the Senate Banking and Currency Committee in 1931. (See Hearings on Banking Systems, 1931, Appendix, Part VII.)

The trouble was that the banks considered as a group did not have the right kind of paper. Moreover, no banking system can stand up under a stampede to convert most of the claims against it into gold and currency. Modern banking systems are not planned on that principle and cannot be expected to function under it.

It is desirable, therefore, that the banking system be so managed that the public shall not lose confidence in the banks in the first place. Though the Federal Reserve system has seen that the legitimate business needs for credit have been met, it has not succeeded in maintaining financial stability in the community by preventing the creation of an excessive amount of bank credit. The idea that the system was essentially nothing more than an emergency organization has been dominant in the councils of its administration. Federal Reserve officials have looked upon it as an organization to "help out" hard pressed banks rather than as a central banking institution to take the lead in the prevention of inflation and undue speculation in various markets.

If the chief purpose of the Federal Reserve Act be, as has often been held, the supplying of a means of credit control, that purpose has fallen considerably short of reasonable realization. The very concentration of reserves, in view of the multiplication of bank credit upon the central reserve, placed vast discretionary power in the hands of the Federal Reserve officials. During the war they were allowed free rein, indeed were requested by the Treasury department, to expand credit freely; and this expansion was excused on the ground of winning the war.

Following the war, during the decade of the '20s, with reserves swollen by the inrush of gold from abroad, inflationary interests among bankers, and securities market promoters attained their objective and took the nation's gold reserves into their service. The Federal Reserve system had no remedial influence on the use of bank credit and central reserves in security speculation and investment operations. Considerable responsibility for the failure to alter what was held, during the banking reform period, to be the prime and pressing evil, rests upon Federal Reserve open market

policy and the war amendment to the Federal Reserve Act authorizing direct loans to member banks on the basis of government securities. This type of lending largely replaced the rediscounting of commercial paper and hence seriously interfered with the capacity of the Reserve banks to regulate the creation of bank credit.

Federal Reserve control over the creation of bank credit was also considerably impaired by the borrowing relationships between correspondent banks. Banks have known that they could obtain funds from their city correspondents. They have consequently continued to ask for and secure them. Such correspondent lending has tended to weaken the character of bank assets inasmuch as the banks were not required to hold the quality of paper necessary for borrowing from a Federal Reserve bank. The continuance of the correspondent borrowing relationships developed under the old national banking system must, therefore, bear its share of responsibility for the non-liquid condition of American bank portfolios and hence for bank failures. Furthermore, competition between the state banks on the one hand and national banks on the other has tended to prevent the raising of the standards of commercial banking.

The Federal Reserve system has not operated to relate the expansion and contraction of bank credit to the needs of industry and commerce. The elasticity of currency which the Reserve system was expected to furnish has practically meant expansion of the currency. Such elasticity of the currency as has occurred was brought about not so much by the rediscounting of commercial paper, as was anticipated, but by the existence of large holdings of gold in the Federal Reserve banks and the presence of large quantities of United States Government securities among the assets of member banks. Furthermore, the Federal Reserve system has been to a considerable degree an investment banking system and thus not fulfilling the purposes of its establishment in serving commercial banking.

Throughout the existence of the Reserve system relatively little commercial paper has been held as security for the Federal Reserve notes. The intended elasticity of Federal

Reserve notes has been set aside in two ways, (1) by the issuance of the bank notes upon the basis of gold, and (2) by their issuance upon the basis of United States Government securities, at first indirectly and later directly. In neither case is there any necessary correlative connection between the amount of bank notes issued and the volume of self-liquidating business transactions. Federal Reserve notes, for the most part, have been in effect gold certificates, or "bond-secured" notes which the Federal Reserve Act was designed to abolish.

Nevertheless, with all of its shortcomings, there has been attained during the twenty years of the Federal Reserve system a degree of control over bank credit which was not possible before 1914. Credit extension has not been left to the free play of independent competitive banks. Progress has been made in the regulation of credit within limits in relation to chosen criteria. Considerations of general welfare have supplemented the profit motive so that banking has been controlled to a greater extent than formerly from a national point of view.

Money and credit, being fundamental factors in our national economy, the quantity and quality of bank credit and the time and manner of its creation are of paramount influence and public concern. The central banking institution is in a position to aid considerably in regulating credit for commerce and industry according to economic requirements and thereby to bring about a greater degree of stability in American economic and social life.

However suited to conditions in the United States the Federal Reserve system may be, a structure operating through a system of checks and balances does not in itself assure sound credit management. As our experience with central banking under the Federal Reserve system has shown, upon its wise administration depends the welfare of the American people. Such an administrative task may be aided by the development of understanding on the part of the people, and the creation of an informed public opinion which may intelligently serve to enforce sound central banking policies.

APPENDIX I
BY-LAWS OF THE FEDERAL RESERVE BANK OF
NEW YORK *

ARTICLE I.—DIRECTORS

Section 1. **QUORUM.**—A majority of the directors shall constitute a quorum for the transaction of business, but less than a quorum may adjourn from time to time until a quorum is in attendance.

Section 2. **VACANCIES.**—As soon as practicable after the occurrence of any vacancy in the membership of the board the chairman of the board shall take such steps as may be necessary to cause such vacancy to be filled in the manner provided by law.

Section 3. **MEETINGS.**—There shall be a regular meeting of the board every Thursday at 2 o'clock P.M., unless that day be a holiday when the meeting is to be held on the next business day, unless otherwise ordered by the board. The chairman of the board may call a special meeting at any time and shall do so upon the written request of any three directors or of the governor. Notice of special meetings shall be given by mail or by telegraph. If given by mail, such notice shall be mailed at least two days before the date of the meeting. If given by telegraph, such notice shall be dispatched at least twenty-four hours before the date of the meeting. Notice of any meeting may be dispensed with if each of the directors shall in writing or by telegraph waive such notice.

Section 4. **POWERS.**—The business of this bank shall be conducted under the supervision and control of its board of directors, subject to the supervision vested by law in the Federal Reserve Board. The board of directors shall appoint the officers and fix their compensation.

The board may appoint counsel for the bank with such duties and compensation as the board may determine.

Section 5. **SPECIAL COMMITTEES.**—Special business of the bank may be referred from time to time to special committees, which shall exercise such powers as the board may delegate to them.

* In effect January 1, 1929.

Section. 6. ORDER OF BUSINESS.—The board may from time to time make such regulations as to order of business as may seem to it desirable.

ARTICLE II.—EXECUTIVE COMMITTEE

Section 1. HOW CONSTITUTED.—There shall be an executive committee consisting of the governor (or, in his absence, a deputy governor), the chairman of the board of directors and three or more directors chosen by the board, who shall serve during the pleasure of the board or for terms fixed by it. Not less than three members of the committee shall constitute a quorum for the transaction of business, and action by the committee shall be upon the vote of a majority of those present at any meeting of the committee.

The committee shall have power to fix the time and place of holding regular or special meetings and the method of giving notice thereof.

Minutes of all meetings of the executive committee shall be kept by the secretary, or an assistant secretary, and such minutes shall be submitted to the members of the board of directors at its next succeeding meeting. Such minutes or a digest thereof shall be read to the meeting if requested by any member of the board.

Section 2. POWERS.—Subject to the supervision and control of the board of directors, as set forth in Article I, section 4, the executive committee shall have the following powers:

- (a) To pass upon all discounts and advances.
- (b) To apply for and provide for the security of such Federal Reserve notes as may, in the judgment of the committee or of the board, be necessary for the general requirements of the bank.
- (c) To employ or to delegate to officers of the bank authority to employ clerks and other subordinates and to define their duties and to fix their compensation.
- (d) To approve bonds furnished by the officers and employees of the bank and to provide for their custody.
- (e) To exercise such other powers as may be from time to time delegated to such committee by the board of directors.
- (f) In general, to direct the business of the bank, subject to the supervision and control of the board of directors.

ARTICLE III.—OFFICERS

Section 1. The board of directors shall in January of each year appoint a governor, one or more deputy governors, one or more

assistant deputy governors, one or more managers of departments of the bank, a secretary, and a general auditor, and shall have power at other times during the year whenever for any reason the offices of governor, or deputy governor, or assistant deputy governor, or manager, or general auditor, or secretary, are vacant to make appointments to fill such positions, and shall have power from time to time to appoint such additional deputy governors, assistant deputy governors, managers, and such other officers as the board may determine to be necessary and appropriate for the conduct of the business of the bank. The secretary may hold at the same time the position of deputy governor, or assistant deputy governor, or manager. The officers chosen by the board shall hold office during the pleasure of the board.

Section 2. CHAIRMAN OF THE BOARD.—The chairman of the board shall preside at all meetings thereof and shall perform such other duties as the board may require.

Section 3. DEPUTY CHAIRMAN.—In the absence or disability of the chairman, his powers shall be exercised and his duties performed by the deputy chairman.

In the absence of both the chairman and deputy chairman, the third Class C director shall preside at meetings of the board.

Section 4. GOVERNOR.—Subject to the supervision and control of the board of directors, the governor shall have general charge and control of the business and affairs of the bank. He shall have power to make any and all transfers of securities or other property of the bank which may be authorized to be sold or transferred by the executive committee or by the board. The governor shall have power to prescribe the duties of all subordinate officers and agents of the bank where such duties are not specifically prescribed by law or by the board of directors or by the executive committee or by the by-laws. The governor may suspend or remove any employee of the bank.

Section 5. DEPUTY GOVERNORS.—The duties of the deputy governors shall be such as may from time to time be prescribed by the governor, where such duties are not specifically prescribed by the board of directors, or by the executive committee.

Section 6. ASSISTANT DEPUTY GOVERNORS.—The duties of the assistant deputy governors shall be such as may from time to time be prescribed by the governor, where such duties are not specifically prescribed by the board of directors, or by the executive committee.

Section 7. **MANAGERS.**—The duties of the managers shall be such as may from time to time be prescribed by the governor, where such duties are not specifically prescribed by the board of directors, or by the executive committee.

Section 8. **SECRETARY.**—The secretary or an assistant secretary shall keep the minutes of all meetings of the board and of all committees thereof. He shall have custody of the seal of the bank with power to affix same to certificates of stock of the bank, to acknowledgements of assignments of registered bonds of the United States, and to such instruments the execution of which may from time to time be authorized by the board or by the executive committee. The board of directors may, in the absence or disability of the secretary, or upon other occasion when in the discretion of the board greater convenience can be attained appoint a secretary pro tem, or empower one or more officers to affix the seal of the bank to certificates of stock or other instruments. The secretary and the assistant secretary shall have such other duties as may from time to time be prescribed by the governor, where such duties are not specifically prescribed by the board of directors, or by the executive committee.

ARTICLE IV.—CERTIFICATES OF STOCK

All certificates of stock, or of payment of or on account of stock subscriptions shall be signed by the governor or a deputy governor and the secretary or an assistant secretary, or such other officers as may be prescribed by the board, and shall be countersigned by the Federal Reserve agent or an assistant Federal Reserve agent; and such certificates shall bear the corporate seal.

ARTICLE V.—BUSINESS HOURS

The bank shall be open for business from 10 o'clock to 3 o'clock on each week day except Saturday, on which day it shall be open for business from 10 o'clock to 12 o'clock, and except that it shall not be open for business on days or parts of days established as legal holidays.

ARTICLE VI.—AMENDMENTS

These by-laws may be amended at any regular meeting of the board by a majority vote of the entire board: Provided, however, that a copy of such amendment shall have been mailed to each member at least five days prior to such meeting, unless waiver thereof shall have been made in writing.

APPENDIX II

DIRECTORS OF THE FEDERAL RESERVE BANK OF NEW YORK

Of the nine directors of the Federal Reserve Bank of New York, the member banks voting in the three groups mentioned below elect six, of whom three *may* be bankers and three *must* be actively engaged in commerce, agriculture or industry in the district. The remaining three are appointed by the Federal Reserve Board and they and the three business-men directors may have no other banking connections while serving as directors.

Group 1, Banks having capital and surplus in excess of \$1,999,000

Group 2, Banks having capital and surplus not exceeding \$1,999,000 and not below \$201,000

Group 3, Banks having capital and surplus below \$201,000

Class	Director	Residence	Business Firm or Affiliation	Character of Business	Group *	Tenure	
						From	To
A	F. D. Locke	Buffalo, N. Y.	Vice Pres., Mfrs. & Traders National Bank	Banking	3	October 1914	December 31, 1918
A	Charles Smith	Oneonta, N. Y.	President, Citizens National Bank	"	3	January 1, 1919	December 31, 1924
A	Delmar Runkle	Hoosick Falls, N. Y.	President, Peoples National Bank	"	3	January 1, 1925	December 31, 1930
A	William Woodward	New York City	President, Hanover National Bank	"	1	October 1914	December 31, 1919
A	Jas. S. Alexander	New York City	President, National Bank of Commerce	"	1	January 1, 1920	December 31, 1922
A	Gates W. McGarrah	New York City	Chairman, Mechanics & Metals National Bank	"	1	January 1, 1923	December 31, 1925
A	R. H. Treman	Ithaca, N. Y.	President, Tompkins County National Bank	"	2	October 1914	December 31, 1929
A	J. E. Reynolds	New York City	President, First National Bank	"	1	January 1, 1926	December 31, 1928
A	C. E. Mitchell	New York City	President, National City Bank	"	1	January 1, 1929	December 31, 1931
A	T. W. Stephens	Montclair, N. J.	President, Bank of Montclair	"	2	January 1, 1930	December 31, 1932
A	David C. Warner	Endicott, N. Y.	President, Endicott Trust Company	"	3	January 1, 1931	December 31, 1933
A	Albert H. Wiggins	New York City	Chairman, Chase National Bank	"	1	January 1, 1932	March 15, 1933
A	Edward K. Mills	Morristown, N. J.	President, Morristown Trust Company	"	2	January 1, 1933	December 31, 1935
A	George W. Davison	New York City	Chairman, Central Hanover Bank and Trust Company	"	1	May 3, 1933	December 31, 1937
A	Cecil R. Berry	Waverly, N. Y.	President, Citizens National Bank	"	3	January 1, 1934	December 31, 1936
B	L. R. Palmer	Croton-on-Hudson, N. Y.	President, Croton Docks Company	Real Estate	3	October 1914	December 31, 1921
B	Frank L. Stevens	North Hoosick, N. Y.	President, Stevens & Thompson, Inc.	Manufacturing	3	January 1, 1922	December 31, 1924
B	S. W. Reyburn	New York City	President, Associated Dry Goods Corporation	Merchandising	3	January 1, 1925	December 31, 1933
B	H. R. Towne	New York City	Chairman, Yale & Towne Manufacturing Company	Manufacturing	1	October 1914	December 31, 1919
B	Chas. A. Stone	New York City	President, American International Corporation	Public Utilities	1	January 1, 1920	December 31, 1922
B	Owen D. Young	New York City	Chairman, General Electric Company	Manufacturing	1	January 1, 1923	January 13, 1927
B	W. B. Thompson	Yonkers, N. Y.	President, Inspiration Copper Company	Mining	2	October 1914	December 31, 1919
B	R. H. Williams	Madison, N. J.	Williams & Peters, New York	Merchandising	2	June 1, 1920	April 28, 1923
B	T. F. Whitmarsh	New York City	President, Francis H. Leggett & Company	Merchandising	2	January 1, 1924	December 31, 1932
B	William H. Woodin	New York City	President, American Car & Foundry Company	Manufacturing	1	April 1, 1927	March 3, 1933
B	Walter C. Teagle	New York City	President, Standard Oil Company of New Jersey	Manufacturing	2	January 1, 1933	December 31, 1935
B	Thomas J. Watson	New York City	President, International Business Machines Corporation	Manufacturing	1	May 3, 1933	December 31, 1937
B	Robert T. Stevens	Plainfield, N. J.	President, J. P. Stevens & Company, Inc.	Merchandising	3	January 1, 1934	December 31, 1936
C	Geo. F. Peabody	Lake George, N. Y.	Chairman, American Radiator Company	Financier		October 1914	December 31, 1921
C	C. M. Woolley	New York City	Chairman, Federal Reserve Bank of New York	Manufacturing		January 1, 1922	December 31, 1936
C	Pierre Jay	New York City	National Bank Examiner	Banking		October 1914	December 31, 1926
C	Charles Starek	New York City	Chairman, Ingersoll-Rand Company	Bank Examiner		October 1914	January 31, 1917
C	W. L. Saunders	Plainfield, N. J.	Chairman, General Electric Company	Manufacturing		February 9, 1917	December 31, 1926
C	Owen D. Young	New York City	Chairman, Federal Reserve Bank of New York	Manufacturing		January 13, 1927	December 31, 1935
C	Gates W. McGarrah	New York City	Chairman, Federal Reserve Bank of New York	Banking		February 10, 1927	February 27, 1930
C	J. Herbert Case	Plainfield, N. J.	Chairman, Federal Reserve Bank of New York	Banking		February 27, 1930	December 31, 1937

* The Group number refers to the group classification of the bank which formally *nominated* the director. It does *not* refer to the group classification of the bank with which the director is connected.

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