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THE FEDERAL RESERVE SYSTEM

Lecture

by

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INTRODUCTORY REMARKS - COLONEL I. J. CARR, S.C.

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Gentlemen

The financial structure of the United States is the foundation upon which our industrial resources rest. The Federal Reserve System has made possible the mobilizing of financial resources. In our study of the industrial mobilization of this country for war purposes or emergency purposes we must also know something of the financial mobilization which is made possible by the Federal Reserve System. It has been stated, truthfully I dare say, that in the last war had not the Federal Reserve System then been organized and in operation we would not have been able to put forth the tremendous industrial effort we did during that period.

I am glad to see members of the Planning Branch present this morning, as well as members of the various supply branches, the Chief of Ordnance, and the Staff of the Army War College.

Mr. Robert V. Fleming, President of the Riggs National Bank, Washington, D.C., has very kindly consented to give up some of his valuable time and come to talk to us, informally, on the subject of the Federal Reserve System.

I take great pleasure in introducing Mr. Fleming.

THE FEDERAL RESERVE SYSTEM.

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Gentlemen:

I am very happy to be with you today - especailly glad to be here for the reason that I firmly believe the more everybody in the United States knows about our wonderful banking system the better off the whole country will be. We really have a marvelous system, it stood unusual strains during the World War, those it was never intended to stand and especially at that particular stage of our banking history.

There is a very important bill before Congress amending and protecting some provision of the Act over which Congress has been fighting for about two years. Bankers making a careful study of our financial structure are most anxious to see this bill passed. After I have told you something of the Federal Reserve System I will tell you of the necessity for the passage of that Bill.

In 1907 the country had a panic and President Roosevelt appointed a National Monetary Commission whose duty was to examine and look into all our ills - mobilization of reserves, examination of foreign banking systems, etc., - and to make a report thereon. This Commission consisted of twenty members, and in 1912 they brought in their report which covered many volumes.

The Federal Reserve System plan was based upon the report of the National Monetary Commission. There were certain ills that the National Monetary Commission found and disclosed in its report to Congress which the Federal Reserve System was intended to correct. First, there was no provision for the organization and use of the scattered reserves of the banks of the country, second, adequate State and Federal laws restricted the use of bank reserves; third, banks lacked the ability to replenish or increase reserves to meet unusual demands, fourth, at the time reserves were most needed by country banks, they could be obtained only by distressing banks in central reserve cities; fifth, banks were without means of cooperation, sixth, excessive time required for transit items, seventh, there was a marked lack of flexibility of the currency.

Those were the chief ills that the National Monetary Commission cited in its report to be corrected and I will endeavor to show you how the Reserve System endeavored to correct some of those errors.

First, there is the Federal Reserve Board, or the governing board; then there is a Federal Advisory Council; then the Federal Reserve banks and branch banks - the three outstanding divisions of the System.

The Federal Reserve Board originally consisted of five members, two of whom were members ex-officio, The Secretary of the Treasury and the Comptroller of the Currency. The others were appointed by the President with ~~with~~ the consent of the Senate, two of the gentlemen appointed to be schooled in banking. About two years ago Congress amended this Act so there are now eight members.

Next comes the Federal Advisory Council. There are twelve Federal Reserve banks with probably thirty branch banks throughout the country. The Council consists of members from the Boards of Directors of each of these banks, one from each district. Their duty is to meet once a year and to discuss the various business conditions in different sections of the country and advise the Federal Reserve Board of their findings.

Then the Federal Reserve banks themselves. Their make-up consists of the usual line of officers any bank would have, although they designate the president of the bank as a Governor and a vice-president as a Deputy-Governor. They are appointed by a board of directors consisting of nane members; three known as "Class A", three as "Class B" and three as "Class C" directors. The Class A and B directors are elected by the member banks; the Class C directors are gentlemen schooled in pursuits other than banking, and are appointed by the Federal Reserve Board. You see there is a pretty good contact for all committees - "A", the banks; "B", the industrial public; and "C", the Government.

I want to say right here that the Federal Reserve System is entirely self-supporting. It is not a drain on the Federal Government, the members of the Federal Reserve Board are paid by assessment on the Federal Reserve banks and these banks, in turn, make their money out of the use of the reserves of the country placed with them by the member banks - plus their capital. So if any one tells you our banking system is a drain or is increasing the taxes, they are all wrong.

Every National bank in the country was required to subscribe to the capital stock of the Federal Reserve bank in their district. For instance, the National banks in Washington were required to subscribe to the capital stock of the Richmond bank. If a bank did not subscribe and become a member bank, it would forfeit its national charter. The subscriptions to start the Reserve banks were made in proportion to a bank's capital and surplus, and on that stock the Federal Reserve bank was to pay a dividend of six percent. Up to the present time the Federal Reserve has only called for 50 percent of that subscription. The funds of the Federal Reserve banks were made up of reserve of other banks.

We had three single classes of banks - reserve centers, New York, Chicago and St. Louis, reserve cities, sixty or seventy in number (Washington being one); and country banks. Banks in the center reserve are required to keep thirteen percent demand and three percent time; reserve banks, ten percent demand and three percent time; and country banks, seven percent demand and three percent time. These funds, together with the capital and surplus, started the Federal Reserve banks out. Their duties were to loan to banks of their own system when they needed help, either upon their securities or upon their commercial paper, and they were empowered to buy acceptances, Government securities, gold, or other items of that nature.

The duties of the Federal Reserve Board are to keep in close touch with all of the Federal Reserve banks and watch the general credit conditions of the country as a whole. They have the power to compel one Federal Reserve bank to loan to another, and also to state the rate of discount to be charged.

If a bank in Atlanta would need money to make loans to move the cotton crop and did not have sufficient money on hand to loan to other banks, the Federal Reserve Board co ld compel the Federal Reserve bank of New York or Boston to loan such sums as deemed advisable to the Atlanta Bank and subscribe the rate of discount. That makes it possible to move the reserves of the country from one place to another in times of stress. Under the old system the reserves of the country were carried one-half in cash in the banks and the other half in the central or reserve centers. The country banker had his cash in his own till or in a central reserve city and the bank in the reserve center had one-half cash or one-half in central reserves. The reserves of the country flowed onto those three cities. Those banks took those reserves and loaned them out and in a particular period of stress there was no way that they could be moved to help the banker in the particular locality requiring aid. The reserves are now mobilized so they can be shifted almost at will.

So far the Federal Reserve Board has never been forced to exercise its power to force the banks to lend to one another, but could do so in case of necessity.

The Federal Reserve banks furnish a very wonderful service not only to the banks who deal with them but to banks who are not members as well as to the public. The membership is made up of State and National banks. When they become members they are, of course, governed by the Federal Law as well as State law. The Federal Reserve banks collect all of the transit items from various points.

For instance, today we may receive a thousand items from all over the country. In the days gone by that would have cost a great deal of money to collect. Now, through an inter-wired system of banks which are interlocked by this system, the various reserve banks settle balances daily and by wire. There has been devised a scheme known as the direct routing method whereby we can send out items direct. The banks that are not members get the benefit of this too because every non-member bank deals with one that is and thereby gets the privileges direct. The crediting system has made it possible for checks to be cleared and money received made available as promptly as possible unless the airplane will speed it up more. Eventually we will find that instead of waiting a week for our items on San Francisco to be collected we will send them by airplane and you will see the additional speed-up in business. In addition to that, the Federal Reserve banks loan to the member banks whenever they are in need of assistance. They either loan on securities, liberty bonds, building and land securities, public utilities, etc., on twenty percent margin, and accept for rediscount commercial paper.

When a bank finds it has to take care of some valuable customer and demands have been very heavy for credit at particular seasons, and they see they cannot loan on any more paper, they will rediscount and, in turn, take care of their customer. That prevents a great many failures which are usually the forerunner of a panic.

The Federal Reserve banks also now issue their own currency. Prior to the installation of the Federal Reserve Act the only currency we had was the United States notes and the National bond notes. They were limited by the size of the National bank and the price of the bonds. In times of stress it is necessary to have more money and the supply was limited. The United States is limited to its gold and silver reserves.

Under the old National Bank Act the amount of currency to be issued was limited by the size of the capital of member banks. Under the Federal Reserve system the banks can issue currency against commercial paper. One of the Class C directors is designated as Chairman of the Board of the Bank and the Federal Reserve agent. One of his duties is to receive collateral from the Federal Reserve bank and hold for the Federal Reserve Board. Against this the bank issues its notes. If a bank wanted one million in notes, they would have to have forty percent in gold and sixty percent in commercial paper or bonds. The Federal Reserve banks issue their currency to their member banks. You can therefore see that their ability to issue currency is far greater than under the old system. The banks are only limited by the amount of their gold reserve and commercial paper on securities, whereas in the old system they could only issue notes to the amount of their capital. In addition, they can now issue Federal Reserve bank notes which the Federal Reserve issues against deposits with the Government of these bonds.

The mobilization of reserves and the issuance of currency corrected the two main evils found in the old system. The Federal Reserve System is absolutely free from political influence. The members must not affiliate themselves with any banking corporation and have to keep themselves entirely free from any influences. The men on the boards are very high class. In addition to that, the Federal Reserve System acted as fiscal agent for the Government during the World War. They were the distributing centers of the Liberty Bond securities.

Now, as to some of the changes it is proposed to make in the McFadden Bill. The Federal Reserve Act now allows the National banks to loan on real estate for one year to an amount equal to thirty percent of their savings deposits. Under the new law they can loan up to fifty percent on their deposits during a period of five years. The National banks will be much better prepared to take care of their customers than in the past.

If the Bill passes with the Hull Amendment (which provides that member banks in a state that does not now permit branch banking cannot, after the passage of the Amendment, have branches in those states), the National bank or Federal Reserve could never have a branch and business conditions make it necessary to have branches. State banks, however, could get their State Legislatures to pass a bill authorizing their banks to have branches. That is a very unfair condition. However, that provision only affects banks that do not now have branch banking. It also provides for an undetermined charter for the Federal

Reserve banks. At the present time the charter of the Federal Reserve banks expires in 1935, unless Congress should pass a bill in the meantime. If the new bill passes, it insures the strongest banking system in the world for as long as Congress permits it to live. There is no date for the charter proposed.

Gentlemen, that is a brief outline of what the system constitutes. I have gone more or less over the high spots and possibly have not made myself as clear as possible. If some questions have come to your minds, I would be glad to answer them.

OPEN DISCUSSION - SCHOOL.

QUESTION

What affect does rediscounting have on the general business?

ANSWER

The discount rate of each Federal Reserve District is governed by the action of the Board of Directors of each Federal Reserve Bank. Of course the bank exercises an influence on the discount. For instance, in New York the rediscount rate is four percent, if it went to three and one-half the money would be cheaper. It would have a tendency for various people to go to the bank and get commercial notes at a lower rate, probably speeding businees up a little bit.

The Federal Reserve Boards are most guarded before changing rediscount rates. For instance, the rediscount rate is never changed until after the stock market is closed. It affects the whole securities market.

Usually the rate is determined by the conditions of the Federal Reserve bank as to what is necessary to be earned, also the ability of the banks in their own district to pay. It is not the aim of the Federal Reserve System to create an expansion in this country or an inflation. If they loan money at two percent to their member banks and the member banks could get six from their customers, they borrow all the money they can to make that spread. There is not much difference in commercial features in that spread.

QUESTION

Does a Federal Reserve bank often have to resort to open market operations to control rediscount rates?

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ANSWER

They often resort to open market transactions when there is a lack of requests for loans. There was a time after the war when the System was strained to the limit in order to take care of the loans. At that time the Federal Reserve Board put in a system which was criticised. Governor Harding was then in charge and the rediscount rate went up to ten or fifteen percent. It was done in order to discourage inflation. Then there came a period when all that was cleared up and banks are now borrowing very little. Federal Reserve banks have to buy from the open market in order to make sufficient money to pay their salaries and to pay their six percent dividends from their member banks. I do not believe the Federal Reserve banks have ever deliberately gone into the open market operations simply to expand or contract the rate.

QUESTION

Is there not a Federal Reserve ratio - a gold reserve?

ANSWER

That gold reserve is based entirely upon the transactions they have with their member banks. They have most of the gold reserve of the country now and it goes up or down, according to the numbers of the notes issued in proportion to their gold.

QUESTION

Is that affected by the open market purchases at all?

ANSWER

It would only be affected by the rediscount from the member banks because they would not be issuing notes to the public which affect the gold ratio when they are buying open market items. They are doing that only as I explained a minute ago.