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THE FEDERAL RESERVE SYSTEM.

Lecture

by

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The Federal Reserve System was made possible by an Act of Congress approved December 23, 1913, and was known as the Federal Reserve Act. The title of the Act describes exactly what it was intended to do - an Act to provide for the establishment of our Federal Reserve banks, to furnish an elastic currency, and to afford means of rediscounting commercial paper.

Prior to the passage of that Act we had, as we have now, two kinds of banks - National and State. The State banks were operated entirely under state laws. The National Banking System was established at the close of the Civil War in 1864 and was found to be imperfect in many respects. Although the best that could be devised at that time, it did not provide for the mobilization of reserves in central points in the United States.

In 1907 this country had a very serious panic. A commission, known as the National Monetary Commission, was appointed with the power to look into our banking system with the idea in mind of determining whether or not a law could be drawn to correct the evils existing that allowed panics to form and caused disturbance to business and industrial conditions. This Commission consisted of sixteen members. At the close of President Taft's administration, in 1912, they rendered their report. This report gave the following as reasons why the members of the Commission believed the National Banking Act inadequate. These points were brought to the attention of Congress and out of this information came the data for the formation of the Federal Reserve Act. The points covered were as follows:

(1) There was no provision for the organization and use of the scattered reserves of the country.

(2) There were many state and Federal laws which restricted the use of reserves; thus the money was not available for use during periods of stress.

(3) Banks lacked the ability to replenish or increase reserves to meet unusual demands.

(4) The country was hampered by the fact that at times when reserves were most needed by country banks they could be obtained only by issuing banks in the central reserve cities.

(5) Banks were without means of cooperation in times of stress.

(6) Lack of established market and of commercial paper tended to encourage speculation.

(7) There was a marked lack of flexibility in currency between different sections of the country.

The Federal Reserve Act was passed during President Wilson's administration. It provided that there should be three units to the Federal Reserve System - (1) The Federal Reserve Board; (2) The

Federal Advisory Council; and (3) The Federal Reserve Banks. You will see how these three units tie in with each other, making the system elastic and providing for safe administration, from the following description which I will give you.

The Federal Reserve Board is the governing body of the System and at present consists of eight members. Originally the membership was seven but the Farm Bloc demanded an additional Agricultural member. Six members are appointed by the President, with the consent of the Congress, and the other two are members ex-officio --- the Secretary of the Treasury and the Comptroller of the Currency. The latter two members hold their places on the Board during their term of office. Of the six members appointed, two must be experienced in banking or finance and not more than one can be selected from any one Federal Reserve District. The period for which they were appointed was originally terms of two, four, six, eight and ten years. The reason for that was that the Act did not contemplate any break in the continuity of the policies of the system, and as members of the Board's terms expired they wanted other members to remain so that someone would be familiar with the policies and general procedure.

Each member of the Federal Reserve Board receives an annual salary of $12,000 - with the exception of the Secretary of the Treasury and the Comptroller of Currency. There is one thing I want to touch on right here in regard to their salaries. The Federal Reserve System is entirely self-supporting. In no way does the Federal Government appropriate any money for its maintenance.

Of the six members of the Board appointed by the President, the Act provides that one shall be designated as Governor of the Board and another as Vice-Governor. In other that there may be no influence exercised on the Board, the Act also provides that no member shall be a director or hold stock in any bank while acting as a member of the Federal Reserve Board. You may recall that Mr. Mellon retired from all boards on which he was a director because as a member of the Federal Reserve Board he could not serve in connection with other activities.

It is the duty of the Board to furnish the policies of the System. They also have a very important power and one concerning which there has been some active discussion during the past six months. They have the power to make one Federal Reserve Bank lend to another Reserve Bank, as well as to fix the rate of interest at which this money is to be loaned. That is a very important power, enabling the governing body to shift reserves in time of stress.

The Federal Advisory Council consists of one member from the Board of directors of each Federal Reserve bank. They are required to meet in Washington at least four times a year or oftener if the Federal Reserve Board directs them to do so. They confer with the Board on general business conditions, keeping the Board in touch with conditions all over the country. It is obvious that the Board, even though it has six members appointed from the various sections of the country, cannot be thoroughly familiar with conditions in every district.

The Federal Reserve banks are the actual operating units of the System. The Act provided that there should be twelve Federal Reserve banks, the country to be divided into twelve districts. Those districts were not necessarily bound by state lines. Take the Fifth District for example; it comprises the States of New Jersey, New York, Virginia, North Carolina, South Carolina, and a portion of West Virginia. The headquarters of the twelve districts are located in the following cities: (1) Boston; (2) New York City, (Brooklyn is not included therein); (3) Philadelphia; (4) Cleveland; (5) Richmond; (6) Atlanta; (7) Chicago; (8) St. Louis; (9) Minneapolis; (10) Kansas City; (11) Dallas; and (12) San Francisco. At the present time there are twelve Federal Reserve Banks and between twenty-seven and twenty-eight branches. Each Fed ral Reserve bank has the power to open branches with the approval of the Board, upon vote of its directors. In our own district a branch bank has been recently located at Charlotte, N.C., and another at Baltimore, Md.

Each Federal Reserve bank is managed by a board of directors consisting of nine members. Of these nine members, six are elected for a term of thr e years each and three are appointed by the Federal Reserve Board. The original directors were elected for terms of one, two and three years - two directors being elected each year and one appointed by the Board. These board members are divided into three classes - A, B, and C. Class A, (3 in number), are the gentlemen who are supposed to represent the member banks. Class B directors are elected by the member banks but must be gentlemen engaged in some business other than banking, perhaps following business or commercial pursuits. The Class C directors are appointed by the Federal Reserve Board. Of the Class C directors, one is designated by the Federal Reserve Board as Chairman of the board of directors of the Federal Reserve bank. He is not only the Chairman of the board but is also designated as Federal Reserve Agent and is, therefore, the District Representative of the Federal Reserve Board. In addition to his duties as Chairman of the board, it is also his duty to transact as Federal Reserve Agent such business as the Board may entrust to his care.

The officers of a bank are a Governor; one or more Deputy-governors; Cashier; one or more Deputy-cashiers; and an Auditor or Comptroller. These officers are appointed annually by the directors of the Federal Reserve banks.

The Federal Reserve banks are bankers' banks - they do not deal with individuals. At the beginning of the system, in order to make it operative, every national bank was required to become a member. They were given a certain time limit; if in nine months they did not become members they forfeited their national charter and either had to go out of existence or obtain a state charter.

In order to furnish the Federal Reserve banks the necessary capital to start with, each member of the system and such state banks as desired to become members (and could meet the requirements of the Board) were required to subscribe an amount equal to six per-cent of their paid-in capital and surplus. One half of this money surplus was paid in at the time a bank became a member. In this connection it is interesting to note that even with the stress of the war strain the Federal Reserve System stood and carried us through so successfully that they have only called for that original one-half subscription. Each member bank receives as a rate on its investment a dividend of six percent on their investment in stock. This dividend is also free of taxation. Of course it cannot be paid until after all of the operating and running expenses of the Federal Reserve banks have been paid.

The above has given you gentlemen an outline of the organization of the Federal Reserve System. We will next take up the working of that System.

The principal functions of the Federal Reserve Banks are to - first, affect concentration in the mobilization of the reserves of the members; second, to provide for an elastic currency and for issuing Federal Reserve notes; and third, afford means of rediscounting commercial paper.

Going back to the National Banking System, the national banks or associations were divided into three classes - banks in central reserve cities (New York, Chicago and St. Louis); reserve centers (sixty-four in number, about the size of Washington and Philadelphia); and all other banks which were known as country banks. Each bank was required to keep a certain portion of its customers' money or deposits in reserve. Banks in the central reserve cities were required to keep in actual cash an amount equal to twenty-five percent of their deposits.

The banks in the reserve cities were required to keep twenty-five percent of their deposit liabilities - one half in their own vaults and the other half in the central reserve cities. You can see that in the sixty-four reserve centers, which were the large cities of the country, one-half of the reserves were kept; the other half being sent to the three central reserve cities to be held there in addition to the reserve those banks were required to maintain. Country banks were required to keep 15% of their deposit liabilities and this was divided as follows - three-fifths to be kept in central reserve cities and two-fifths in cash.

The above brought about the following situation. Banks in central and reserve cities carried as much as was allowed by law. In fact the bank reserves of the United States were carried in those three cities. Naturally the banks in those cities loaned those funds out up to seventy-five percent of the amount they had on hand. When there were times of stress and the country banks desired help they could not always get their money. Thus panics were created. The reserves were tied up in loans. There was no way in which money could be shifted from one section to another and money shortages were created - panics following. It is practically impossible for a panic to occur under the Federal Reserve System.

Under the Federal Reserve Act these requirements were changed. The amount to be carried in banks was lowered but at the same time a scheme was devised whereby it was possible to make the money movable. All members were required to keep their accounts with the

Federal Reserve banks of their district. These banks got their capital from the paid in money of the member banks. The Riggs National Bank keeps an average account with Richmond of about three million dollars.

Under the new system, banks in the central reserve cities are required to keep thirteen percent of their demand deposits (or checking accounts) and three percent of their time deposits (or saving accounts) with the Federal Reserve Banks. No till cash counts. Under the Federal Reserve System the amount of cash carried is simply for the convenience of the customers. Under the old system the banks in the central reserve cities had to carry twenty-five percent cash. That money was tied up and could not be used. Banks in the reserve cities are required to keep ten percent of their demand and three percent of their time. You will recall that under the old system the banks kept twenty-five percent (12½% in central reserve and 12½% in cash). Country banks are required to keep seven percent demand and three percent time. There was quite a reduction in the amount of reserve carried, as you can see from the foregoing.

You now have the picture of all the national banks of the country as members of the Federal Reserve System. Many state banks are also members of the System. The reserve accounts of all those banks are now kept with the banks of the district in which they are located. All the reserve of the country is located in the twelve banks and their branches. You can readily see the comparison of the reserve as maintained under the National Banking System and under the Federal Reserve System. Under the former, the reserves were located in three cities and those cities were not restricted as to the type of loans they could put the reserves into. The banks could make loans of every description. There has been times in the country when loans known as brokers' loans (considered as absolutely liquid) have been completely frozen. Panics came into being and banks could not get their money. There was no buying power and the reserves of the country were tied up in the three cities - New York, Chicago and St. Louis.

Under the Federal Reserve System the twelve banks and their branches care for the reserves of the country.

We now come to the power of the Federal Reserve Board to require one bank to loan to another. The moving of the tobacco and cotton crops requires a lot of money. The grain season in the Northwest requires a lot of credit to be extended by the banks. Under the Federal Reserve System if the banks in the Fifth District, which are caring for the moving of tobacco and cotton, need money and their Federal Reserve bank of Richmond does not have enough money to do that, they can appeal to the Board and the Board can say to another bank, perhaps New York or Boston, "We want you to loan the money to Richmond at three and one-half percent". This money would immediately go to Richmond and the reserves of the New York or Boston bank would be used for moving the crops in the Fifth District. That could not be done under the National Banking System.

The second function of the Fed ral Reserve banks is to provide an elastic currency by the issuance of Federal Reserve notes. The national banks were required to invest in notes equal to the amount of their capital. You can see that outside of U.S. currency, gold notes and silver certificates, the other currency was limited to the amount of capital in the National banks of the country. That also created a money shortage.

In the Federal Reserve Act Congress endeavored to create a machinery by which more money could be put into circulation. It is true that runs up the till cash but it allows the banks to only carry as much cash as they want to do business with. That Act provided that the Federal Reserve banks should issue notes known as the Federal Reserve notes. By the way, that is one of the duties of the Federal Reserve Agents. They issue these notes to the member banks against the loans of the member banks - secured by U.S. Government obligations or against commercial paper. In all cases the limitations of the Federal Reserve banks to issue these notes is based upon what is known as a 40% gold reserve of notes outstanding. Of course they can buy gold bullion or have on hand the notes issued by the Federal Government. This provides for nearly an unlimited supply of currency. In addition to the Federal Reserve notes, the banks are allowed to issue Federal Reserve bank notes. They give an additional meaning of currency. These notes can be issued with the approval of the Board.

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I want to bring to your attention one other point in regard to the elasticity of the System. Prior to the establishment of the Federal Reserve Act checks and drafts received by the national banks could only be collected through means of correspondence. For instance, if we received checks on San Francisco, the only way we could collect them was to mail them out to San Francisco - that took six days going and six days coming back. Thus the money involved was tied up for twelve days. The Federal Reserve Act provided for a collection system and started collecting items for the member banks at a small cost, at actual operating cost to be exact. Now they collect without any charge. That system works as follows: it is used as a medium for the collection of all items through the banks, and settlement of claims and transactions between the banks. This is based on our scheme known as the gold settlement fund, which requires that each bank must deposit a certain amount of gold with the Federal Reserve Board. All Federal Reserve banks are hooked up with an inter-wire telegraphic system so that every day their individual debit and credit balances are settled in this fund. That is rather remarkable when we think that every day the transactions are settled and balanced by wire. In establishing that system Congress had this in mind. They wanted to get away from the time delay that occured in the collection of transit items, so consequently the items were sent to the Federal Reserve banks of the districts and they in turn gave each member bank what is known as a deferment schedule. Based on that schedule they automatically credited to the account of the member bank the amount as represented by the checks.

The system has been improved by utilizing what is known as the direct routing system. We can now send direct to the Federal Reserve bank of New York such items as we may have on member banks of New York City; when those items get to New York we are credited with the amounts in Richmond and we can use that as cash. The same holds good with San Francisco; five days after their receipt in that city we can use the money in Richmond. That is all handled through the gold settlement fund. The development of the airplane will speed up the settlement quicker. When that development takes place, and aviation is made safer, we will be very much closer together and money will be turned over very much more rapidly.

The above briefly gives you an outline of the Federal Reserve System. Like all laws this one did not provide for all changing conditions and some of the member banks found they could not compete with the state banks. The state banks were given more power. The Federal Congress recognizing that situation, passed an Act known as the McFadden Act which increased the powers of the Federal Reserve System. Attempting to equalize under the proper government legislation the powers between national and state banks, under the present system a member of a national bank can now do practically everything a state bank can do and at the same time give to the depositors the protection of Federal supervision under the banking laws approved by Congress.