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# THE FEDERAL RESERVE SYSTEM

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# THE FEDERAL RESERVE SYSTEM

As your chairman has said, I have come and given you this lecture now for several years (five years). I looked over the outline this morning that I prepared in 1931, and I found that, while the substance of the Federal Reserve set-up is still the same, there have been so many changes in the general emphasis and the importance of different events that a lecture following the lines that I followed in 1931 would very largely miss the things that are most prominent in our minds.

We have, as you know, gone through a most extraordinary period in this country in every respect, and the financial machinery of the government and of the country has had to adjust itself to an entirely new set of circumstances

I always find it a little difficult to deliver this lecture because I do not know exactly how familiar you are with the set-up and with the system and with the general problems of banking, and so I, perhaps, may say some things that are too elementary and that you are familiar with, but I hope that you will bear with me and I shall try, in a brief way, to indicate the place that the Federal Reserve System occupies in our economic life

The Federal Reserve System in general, as you no doubt know, was started as a cooperative undertaking by banks, under the auspices of the Federal government, under Federal charter, for the purpose of making it possible for banks to have institutions to which they contribute capital and in which their required reserves might be held. By that method they had a reservoir upon which they could draw when their (the individual banks) own resources were not adequate to meet the situation, either because of seasonal difficulties, because of excessive demands of creditors, or because of special circumstances that affected the region or the industry which they served, or that affected the country as a whole In other words, it was a method by which the reserves which the banks have always had to hold idle, under our law, could be pooled together and made available for meeting exceptional situations in different places That was the original purpose of the Federal Reserve System, that, together with supplying an elastic currency and improving the supervision of banking in this country

The original purpose of the Federal Reserve System to serve as an emergency agency available to banks, which may have used up their own resources for meeting legitimate demands of trade and industry, is still an important function of the Federal Reserve Banks but is no longer the principal function, certainly not at the present time because owing to circumstances, much broader than I can outline in this brief talk, the banks all have such a superabundance of funds at this time that there has not been for several years, any occasion for banks to come to the Federal Reserve Banks for borrowing, so that as a place of last resort to which the banks can turn to meet the additional demands for credit when their own reserve resources do not suffice, the Federal Reserve System at the present is not needed

However, the other functions of the Federal Reserve System, which were only vaguely realized at the time it was established, have become increasingly important as experience has accumulated and as our understanding of the matter has increased The principal function of the Federal Reserve System at the present time is to exert an influence on the supply and cost of credit that becomes available to trade and industry, it is no longer a question primarily of helping out individual banks that are short of resources, nor even helping out the whole banking situation in case of runs or financial difficulties Those things are still functions of the Federal Reserve and may some day become important again, but for the immediate future and for the present the Federal Reserve has, primarily, under its jurisdiction and as its main purpose to influence the cost and the supply of credit that flows through the channels of business. That, of course, as you can see, is a very vital matter because credit, reflected on the liability side of banks in deposits and on the asset side in loans and investments, is the medium through which nine-tenths, or more, of our business is done, and if the Federal Reserve has some influence on the cost of that credit and on the amount of that credit that becomes available to the public it is a very important factor in the economic set-up, and it is, of course, correspondingly a responsibility for the Board of Governors and the Federal Reserve Banks to hold and to discharge.

I suppose you know that the general set-up of the Federal Reserve System is twelve Federal Reserve Banks scattered throughout the country, each serving a different Federal Reserve district. The country is divided into twelve districts All the national banks in each district must be members of the System, and state banks may become members if they choose and if they have the requisite capital and requisite character of business There are six thousand, four hundred members of the system. The capital of the System is supplied by the member banks, which must subscribe six per cent of their capital and surplus to the capital of the Federal Reserve Bank. Three per cent of that has been called and the rest is subscribed but has not been called That is the capital structure of the System, which is not very important because the one hundred and forty million dollars of capital that is supplied to the Federal Reserve Banks by the member banks is a very much smaller part of their funds than the amount that the member banks must hold on deposit with the Federal Reserve banks in order to comply with the law in regard to reserves against their deposit liabilities The banks are supposed to hold a certain amount of reserves against their deposit liabilities on deposit with the Federal Reserve Banks Those required reserves at the present time are somewhere in excess of four billion dollars I will come back to that a little later You can see that the reserves of the member banks make up a very much more important and significant amount in the picture than the one hundred and forty millions of capital which they subscribe

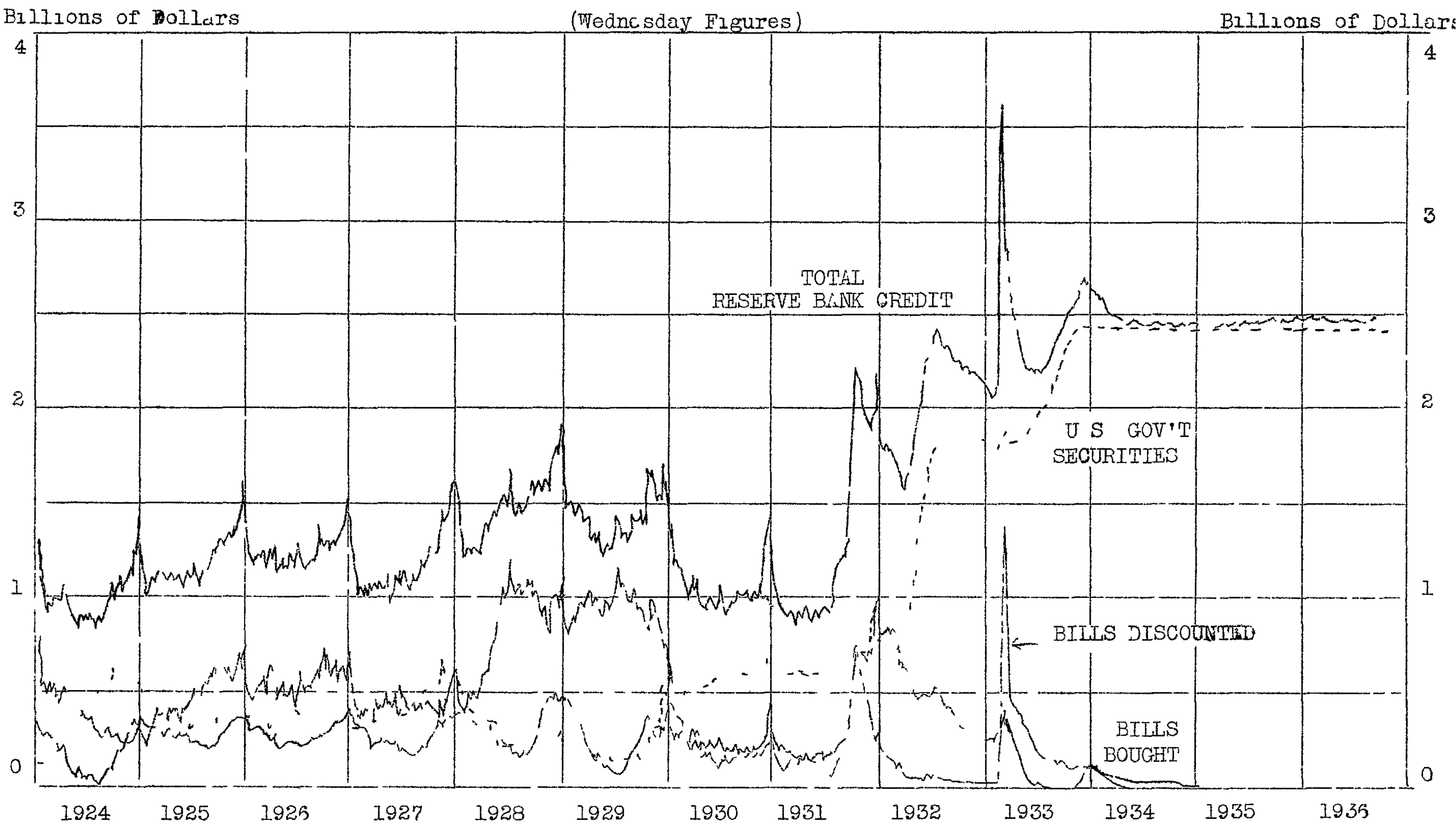
For the management of each of these Federal Reserve Banks we have nine directors, six of whom are elected by their local banks and three of whom are appointed by the Board here in Washington The Federal Reserve Board, which last year was renamed by law "The Board of Governors of the Federal Reserve System," consists of seven men appointed by the President, and they have very vital powers over the Federal Reserve System. They have under their jurisdiction approval of the appointment of the presidents and vice-presidents of the banks, they have the approval of all of the salaries paid by the banks, they have quite complete control over discount rates, which are the rates that are charged by the Reserve Banks to the borrowing member banks, they have complete control over marginal requirements in the securities market, and they have complete control over member bank reserve requirements They have practically complete control over nearly all the instruments of credit except the so-called "open market operations," for the control over which there is set up by law an open market committee consisting of the seven members of the Board of Governors and five presidents of the Federal Reserve Banks elected by groups of Federal Reserve Banks, New York and Boston having one representative, Philadelphia and Cleveland having one, etc When the open market committee meets it consists of seven members of the board and five presidents of the Federal Reserve Banks, so you see that even in that set-up the Board has the majority.

Perhaps I might indicate the two principal classes of operations in which the Federal Reserve Banks engage The distinction between the two classes is primarily that one class of operations is engaged on the initiative of the member banks, and therefore represents a response by the Federal Reserve System to the demands of the situation, and the other is a class of activities engaged in by the Federal Reserve Banks on their own initiative for the purpose of influencing the volume of credit The first class consists of discounts - the second largely of the purchases of securities, chiefly government securities

Perhaps if I can turn to the chart (Chart I) I may be able to point out some things that are pertinent. This shows the three different kinds of operations I have spoken of two Purchase of acceptances is another one, but for simplicity let us disregard them in this discussion The line "Bills Discounted" represents the amount of money that the member banks borrow from the Federal Reserve Banks That is, when a member bank, after having met the local demand for credit, finds that it does not have enough money it can take some of its notes and bills that it has received from the public and rediscount them with the Federal Reserve Bank and thereby increase its ability to serve the community As you can see, this discount line has gone up and down, getting very high during the active period in 1928 and 1929, going way down by 1932, then showing a tremendous rise during the crisis in 1933 and a decline after that, and since then there has practically been no borrowing, which indicates what I said a while ago that the purpose of lending to member banks is practically non-existent for the present because for a matter of three years they have practically borrowed nothing They have not borrowed anything for a number of reasons, among which is the large inflow of gold which has given them funds, another reason is that the Federal Reserve Banks, as a part of their policy during the depression, have purchased a very large volume of government securities They have not purchased any since 1933 and this line (indicating U S Government Securities) has remained still, but there has been plenty of credit without it and we have had large excess reserves, as I will tell you in a little while

Chart 1

VOLUME OF RESERVE BANK CREDIT



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The second class of operations, the purchase and sale of government securities, is represented by another line on the chart During the depression the Federal Reserve bought securities, and when a Federal Reserve Bank buys a security it pays for it by check, the check comes to a member bank, the member bank deposits it with a Federal Reserve Bank and gets a credit and it can then use that money to pay off what it owes the Federal Reserve Bank So you see that whenever the Federal Reserve Banks buy government securities, as they did right here (indicating 1932) in very large amount, a good part of that money was used to pay off the Federal Reserve Bank, and one reason why there is no borrowing is that the Federal Reserve Banks deliberately went out to buy securities in order to put funds at the disposal of the banks so they would not have to borrow, and the reason that was necessary was that with deflation going on, with business in bad condition, with banks reluctant to make any loans to the public, the Federal Reserve Banks have used their influence to put the banks out of debt, to put a large amount of funds at their disposal and make it possible for them to extend credit to the public without going into debt That is the more active function of the Federal Reserve Banks, the function of actually supplying credit, and it is the one that has been very much more prominent in the past five years than it was before, and is likely to continue to be prominent because of the fact that, with the reserves as high as they are and with gold still coming into this country, we are not likely to reach a condition where the member banks are going to be heavily in debt

The functions of the Federal Reserve System as a power to influence the volume and cost of money are very much better understood now than they were when the system was created It is no longer considered an incidental emergency agency, it is considered a part of the regular machinery for influencing in the public interest the flow of credit through the banking system of the country

I read somewhere about a colored man who was applying for a job They asked him whether or not he had any children He said he had a son that was born in 1917 They asked him what his name was and he answered, "Weatherstrip " "Weatherstrip?" That is a funny name Why do you call him "Weatherstrip?" "Because he kept me out of the draft " The Federal Reserve System has ceased to be a weatherstrip to keep the banks out of the draft. It has become an agency that has a much more permanent and a more valid part in our economic life than just to prevent individual banks from having to be exposed to the rigors of a depression The powers of the Federal Reserve System, however, are not as complete as is sometimes believed, although they are better understood and have been definitely increased. For a proper understanding of the Federal Reserve System it is desirable to keep in mind that it never can, under a free economic system, accomplish as much as sometimes is attributed to it by friends and foes alike, nor as much as is sometimes claimed for it at a time when things are going in a satisfactory way

The powers of a system of this sort are limited by a considerable number of considerations, which I cannot enumerate completely, but it is perfectly clear that when, for instance, a depression is under way, a deflation is on, when people are reluctant to borrow, when business men are not sure of an opportunity to make profits and therefore do not wish to borrow money at any price for the purpose of doing business, then putting money into the market and making it cheaply available and plentiful may very easily not result in activity because at certain times people will not borrow at any price It is not only a question of the price of the money, it is a question of the opportunity for using it and of the courage and confidence required in order to use it

So there are limits as to what can be done by monetary means alone in a depression There are also limits to what can be done in an inflation or speculative year In 1928 and 1929 the Federal Reserve System did a great deal towards trying to make money scarce and more expensive in order to restrain the speculative activities which had at that time developed Nevertheless, the speculative fever had gotten such a momentum that the restraining influence of the Federal Reserve System was not sufficient to prevent the great orgy that we went through After all, when a person gambles in the stock market and expects to make ten or fifteen or twenty points profit a day it is not going to be much of a deterrent if he has to pay even as much as thirty per cent a year for his money because thirty per cent a year is less than one-tenth of one per cent a day and if he expects his money to double over night, almost, he is not going to be concerned about the rate of interest So there are limitations in the power of the Federal Reserve System to influence the economic machine, both during a depression and during a speculative boom What it can do and what it should concentrate its effort on doing is to act so promptly and so early in the developments that the forces, which when once loosed become uncontrollable, will not get sufficiently under way to make its interference ineffective That requires more judgment, knowledge, wisdom, courage, and cooperation than so far it has been given to men to have, because it has been almost impossible to know early enough in the game what is going on in order to prevent that part of events that is undesirable

Your chairman has said that it has been my function to give the Board economic counsel I think that that is probably an overstatement of my function, but it is true that the division that I have charge of is supposed to give the Board all the basic information We have a considerable number of people there now who have been working on it for fifteen - twenty years. We have tried to coordinate and present and have available as much information as is possible to throw light on situations, but the trouble with statistics is that they always refer to the past and the actions of the Board deal with the future The curves that we present on charts have stopped yesterday or last week or last month, depending on the frequency of the returns, and the Board has to act on the basis of past facts while the effects of its actions are in the future, and it means, therefore, that we have to forecast and guess as to the future We can improve the character of our guesses by close study of the facts and of the elements involved in the facts, we can improve them by studying past experiences, we do try to the best of our ability to do just that, but nevertheless we can never be in a position to say with positiveness that this is the action you must take because this is going to happen if you do not take it and this is going to happen if you do. If we were in a position to do that we would be perfect, but that degree of perfection is one that I think we will never attain Certainly I have no anticipation of living long enough to be able to have our organization be able to do that However, that unattainable ideal has the great advantage of keeping us in a constant feeling of inadequacy and divine discontent, but it also does place upon us a responsibility that is very, very difficult to discharge I must, at any rate, say this that the Federal Reserve System, which no doubt has made many mistakes, has been the first in the field of central banking to recognize the tremendous importance of studying all the facts, having them available, having them presented adequately, and making their decisions in the light of that information Ordinarily the policy-making bodies of both the Federal Reserve System and all the other central banks of the world consist of men who have distinguished themselves in some field or other, usually a field that is entirely different and requires an understanding different from the understanding necessary for the problems with which they are confronted They are usually people who have been successful and, therefore, have a good deal of self confidence, and it has been the habit of men of most central banking policy-making bodies to act very largely on hunches and confidence in their own judgment Now that is a method which is not, much as it appeals to the successful man, a method that you in the Army would want to pursue in planning a campaign or preparing for one, or in conducting a battle, and it is a method which it is necessary for the policy-making authorities to abandon before they have a chance, one chance in five, of taking action at the right time and in the right direction I think perhaps we can put down as an achievement of the Federal Reserve System that it now recognizes that careful, painstaking study by competent people, with constant reference to the factual background of every event, is an absolute essential for the best results in the direction of the right kind of forecasting and the right kind of diagnosis of an economic situation upon which action is predicated If that is done, then at least the Federal Reserve System can feel that it has done as much as it is possible for it to do

The powers of the Federal Reserve System in recent years have been very considerably enlarged as a result of experience We have new powers now over the loans on securities in the stock market. We found, by very painful experience in 1929, as I intimated a little while ago, that just raising the rates of discount and adopting other ways of making money scarce at a time of speculative orgy is not sufficient to control the situation We have now the power of prescribing rules concerning the amount of money that can be borrowed for the purchase of securities, so that the amount of speculation with the use of credit is limited. For instance, at this time it requires $55 00 in cash in order to buy a hundred dollar security You cannot borrow more than $45.00 on your security in order to carry it. That makes it more difficult for a boom to develop in the stock market I think this margin requirement authority, which was given to the Board in 1934, is probably a very important power because it goes right to the transaction and makes it possible for us, for instance, to put up margin requirements to one hundred per cent, which means that no securities would be bought or sold except for cash If we do that there is not likely to

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develop the kind of speculation that developed in 1929, and it may be that that power will increase the opportunities for the Federal Reserve System to prevent excessive activity.

The Federal Reserve System has also been given power to change the reserve requirements of member banks I think I will take a few minutes of your time to explain what that means because that was reflected in the recent action and is a fairly important matter. Under the law as it was established in 1917, after some amendments, every member bank is supposed to hold a three per cent reserve against all the deposits that it has on time. I mean that time deposits, which cannot be withdrawn without notice, require a three per cent reserve. Demand deposits, those deposits that can be withdrawn upon demand, require a reserve of seven or ten or thirteen per cent, depending on whether the bank is in the country or in a reserve city or in one of the two central reserve cities - Chicago and New York. Those are the legal reserve requirements. In the aggregate they mean that at the end of 1935 there were about two and three-quarter billions of dollars that the member banks had to hold with the Federal Reserve Banks That is the regular law.

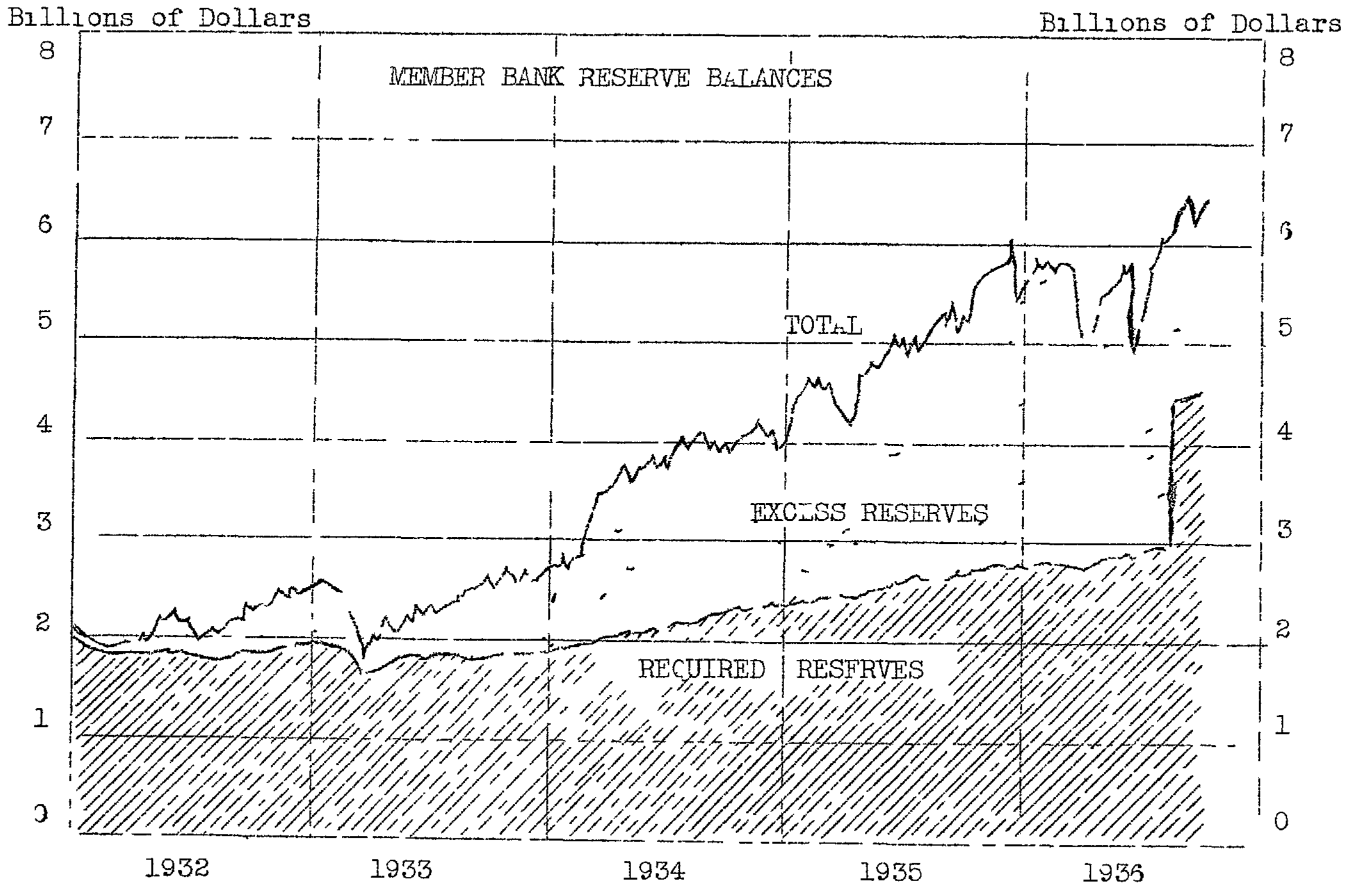
In emergency legislation, and later in the Banking Act of 1935, the Board of Governors was given authority to change member bank reserve requirements, with certain limitations These limitations are that it must not lower requirements below the level prevailing when the law was passed nor raise them more than 100 per cent If the Board finds that the member banks have a very large amount of reserves resulting, say, from gold imports, the Board can say that required reserves need to be higher and they can increase the reserves that the member banks have to hold, within the limitations provided by law. As a matter of fact, last July the Board did increase reserve requirements by fifty per cent, so that against time deposits the member banks now have to hold four and one-half per cent reserves, and against demand deposits ten and one-half, fifteen, and nineteen and one-half per cent depending upon the city. That is the method by which the Federal Reserve Banks at this time put themselves in a better position to control inflationary development if it should happen.

I would like to refer again to a chart (Chart 2) This line here (indicating the top line in the chart) shows the total amount of reserves that the member banks have. As you see, it was two billions in 1932 and since that time has gone up to more than six billions. That increase has been largely due to gold imports, it has not been due very much to anything that has happened in this country, to any credit policy of the Federal Reserve Banks - and the banks have six billions and over of reserves while the reserves required prior to the July action were less than three billions That is, this much (indicating the lower section) they were obliged under the law to hold and this much (indicating the dotted section) they were holding in excess of what they were required to hold. That means that the banks had some three billions of dollars on which they could base a credit expansion of fifteen to one, or forty-five billions of dollars, without having to borrow anything from the Federal Reserve Banks That put the Federal Reserve Banks in a position where it would be very difficult for them to control the situation if an inflationary development should occur While the Board last July said that there was still no inflationary movement and there was no evidence of abuse of credit, there is this tremendous powder magazine that might blow up at any time and the thing for the Board to do is to try to immobilize or sterilize a part of it so as to be in a better position to control things

We do not want at this time to make money more scarce because we are still in the process of recovery and there is no evidence of an undesirable boom In fact, there is still evidence that we have yet a considerable way to go before we have prosperity restored However, the time to act, as I indicated a while ago, is early in order that control measures can be effective when the necessity arises

The law says that we have the right to change reserve requirements to prevent injurious credit expansion, to take preventive action before the thing really gets going The Board raised requirements by fifty per cent, and you see (indicating the lower section) that required reserves increased from something under three billions to something like four and one-half billion dollars, and the amount in excess of requirements diminished from three billions to a billion and a half or two billion dollars That made it more possible for the Federal Reserve Banks to control an inflationary situation if one should develop than it was before As compared with this amount of excess

Chart 2


Billions of Dollars
Billions of Dollars
MEMBER BANK RESERVE BALANCES
TOTAL
EXCESS RESERVES
REQUIRED RESERVES
8
7
6
5
4
3
2
1
0
1932
1933
1934
1935
1936

61

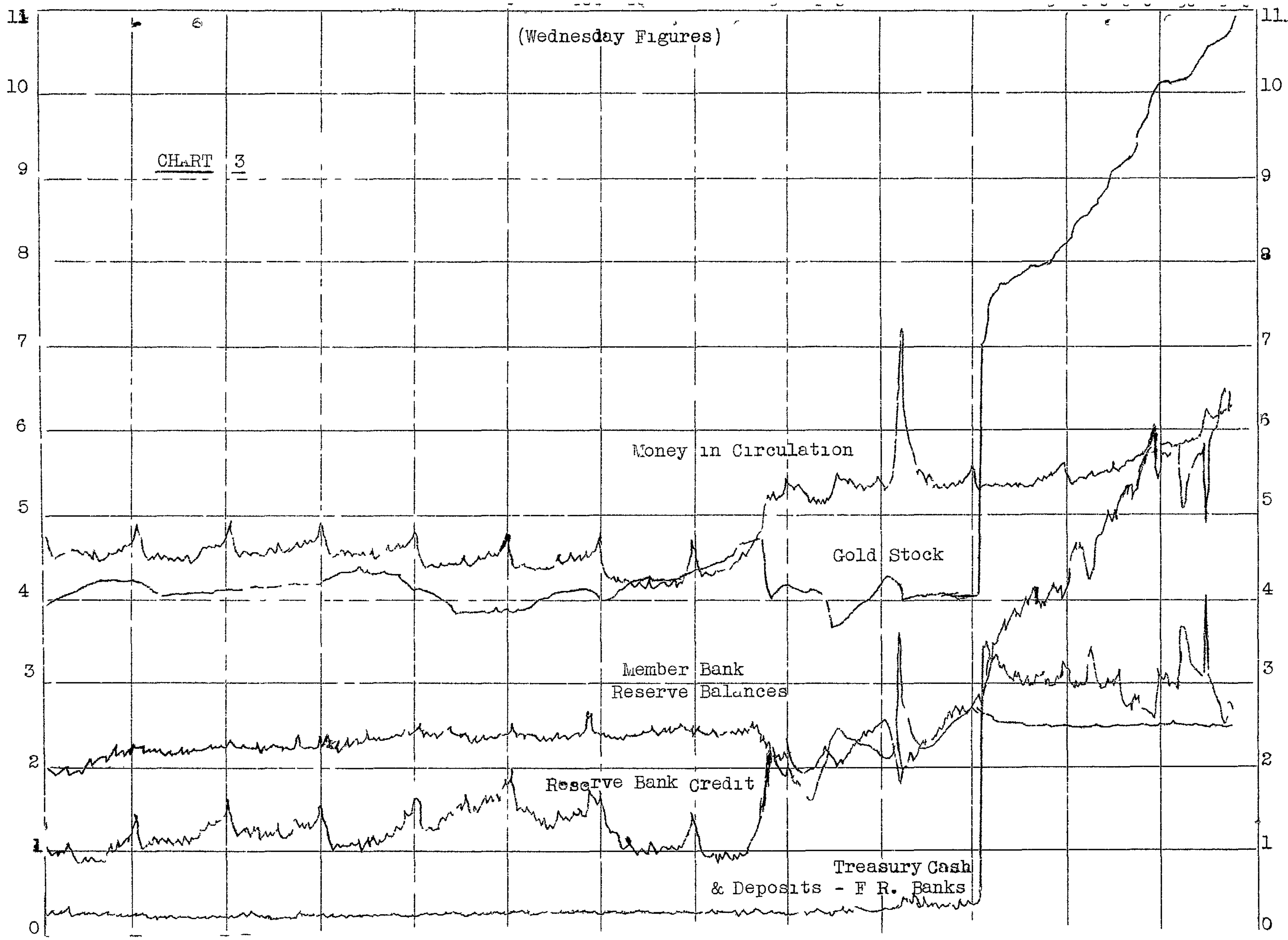
reserves which is something less than two billions, there are nearly two and one-half billions of government securities which the Federal Reserve Banks have, so if an undesirable credit expansion should now occur the Federal Reserve Banks have two and one-half billions of government securities which they can sell, and if they sell a government security that takes the money out of the market and has the same general effect as a raise in reserve requirements.

This recent change in reserve requirements is an exercise of a new power and, of course, it has not yet been tested. We do not know how it is going to work out, but it was a very courageous and new thing to do, speaking frankly. While we have had no reason to expect that it would tighten money or retard recovery, yet it had never been done anywhere in the world and you never can be absolutely sure what is going to happen so long as you haven't any experience to go by Since the retardation of recovery at this time especially, when we still have a good many unemployed and also in a political year when it seems very important to the powers that be that nothing should happen to retard recovery even for a brief period, would have been serious I think it was a very courageous and independent thing for the Board to do As a matter of fact, so far it has not resulted (it should not have resulted and for once it did what it should) in any tightening of money or retardation of recovery In fact it had, to the extent that it had any effect, the opposite effect of restoring confidence somewhat and making the bankers feel that there is a Board here that is as fully aware of the dangers of inflation as it is of the dangers of deflation, and that it is an independent Board that will act on its own judgment I think that that has had some influence in making the banks feel more free in making plans, and has possibly even made business men more free in making future commitments

But, while we have these new powers, and I think we have an extraordinarily good Board at this time, I think depression developments have complicated the problem very considerably because of the very large amount of credit made available by the inflow of gold and because the depression has also resulted in the Treasury of the United States having powers that if utilized not in accordance with the Board's advice and in cooperation with the Board, could neutralize anything that the Board could do For example, as a result of the devaluation of the gold dollar the Treasury got at its command some two billions in gold for a stabilization fund, the spending of which by the Treasury would increase reserves of member banks the same way as open market operations or gold imports would, so that now the Treasury has the power to nullify anything that we might want to do. That is also emphasized by the power of the Treasury to issue silver certificates, which have the same effect. All those things make the situation somewhat more difficult

There is a good deal of talk about the central banks being independent from the government A central bank is never in a position to act independently of any government, in a way, because the government, parliament, or monarch, whichever it happens to be, has sovereign power and a sovereign power will not permit any of its agencies to prevent the accomplishment of its purposes, so that in all cases cooperation is inevitable The Bank of England is mentioned as an entirely private institution with no government control over its activity, and yet we know, as a matter of fact, that the government and the Bank of England always work hand in hand, and the only reason that the Bank of England can sometimes assert its independence is because it has such strong standing and prestige and is in the people's confidence so that the government does not dare defy it, and that perhaps there are occasions when the government does what the bank wishes rather than the bank doing what the government wishes That is a matter of the specific weight of the influence of authority As a matter of actual fact, co-operation of one kind or another is an absolutely essential feature, and as far as I know it has always been very good between the Federal Reserve System and the Treasury, but it does make the problem more difficult because the Treasury might be influenced by considerations of its own that are vital to it from the fiscal point of view, and yet its actions might be interfering with the monetary policy of the Federal Reserve System That is something for which we should have a working agreement and a mutual understanding because the ultimate objectives are the same So far there has, to my knowledge, never been any occasion when the authorities were in conflict, but there is that theoretical possibility and it does further complicate our action.

I do not know whether or not I have time to explain this very crucial chart (Chart 3) which shows all the various elements that enter into the Federal Reserve picture You can see here (indicating the gold stock line) that the outstanding factor of the last few years has been this tremendous inflow of gold This much increase in the gold (indicating February 1934) does not represent an inflow but just a revaluation of the existing gold when the value of the gold dollar was changed from



(Wednesday Figures)
CHART 3
Money in Circulation
Gold Stock
Member Bank
Reserve Balances
Reserve Bank Credit
Treasury Cash
& Deposits - F R. Banks
0
1
2
3
4
5
6
7
8
9
10
11

$20.00 to $35.00 - a jump that took it from four to seven billions. The jump from seven to nearly eleven billions, however, is caused by imports, and that has been a very important factor in the situation. However, this factor has been somewhat diminished in its influence on the banking situation, by the fact that this much of it (indicating the Treasury cash, etc. line), which is the Treasury holdings, has gone up from almost nothing to over three billions As long as the Treasury holds this much (indicating) - that part of the gold which resulted from devaluation, has not gone into the credit picture, and therefore has not been reflected in rising reserves. As long as the Treasury has these holdings, however, it has a potential influence on the market Since the credit supplied by the Federal Reserve Banks is standing stationary, the money in circulation has not changed very much. I will speak of that money in a little while

This line, the reserves of the member banks, has been going up very rapidly; but, as I told you a while ago, part of these reserves have recently been changed from excess to required reserves and, therefore, have ceased to be a basis for credit expansion The situation would depend on whether there is still more gold coming in, whether it would be necessary for the Treasury to use any of its funds in a way that would interfere with control, and whether the Federal Reserve, in case of a run away situation, would be in a position to raise the reserve or to sell some of the securities which it has in its portfolio

I think perhaps there is one thing that I could do to best advantage during the remaining minutes, that is, discuss the currency-supplying functions of the system. Naturally I have to cover so much ground that my comments are not necessarily connected. I do not know how much study you give this subject Possibly if you get interested enough you can fill the gaps by reading There is a book by W. Randolph Burgess, who is the vice-president of the New York bank, that has just come out in new edition on "The Federal Reserve Banks and the Money Market" that I think is an excellent presentation, in considerable detail, of the functions of the Federal Reserve System

The currency-supplying functions of the Federal Reserve Banks are the functions that have been of the greatest public interest Somehow or other the public has not learned yet that money these days is not simply cash in one's pocket and that deposits in the bank are just as important as an element of buying power and as an element in the general economic picture as is cash in vault and, therefore, so much criticism and misrepresentation, as well as pressure for changes in legislation, comes from people who say that the Federal Reserve Banks, owned privately and run for profit, have arrogated to themselves and have acquired from the government its sovereign right to issue money, and that the banks acquire money for the mere cost of printing it and then use that money to buy government securities for which the government has to pay them interest at the expense of the taxpayers The constant pounding along those lines is something that it is very difficult to discuss and explain because people in general know so little about the functions of money

I thought that perhaps it would be worth while to point out three fundamental things about the Federal Reserve System in relation to the supply of currency In the first place, as I have already indicated, the Federal Reserve System is not a privately operated organization in the usual sense of the word It is true that the member banks own the stock but the ownership of the stock is very different from the ownership of stock in a private corporation In the first place, they have no choice about how much stock they will buy or whether they will buy stock If they are member banks they now have to buy stock up to three per cent of capital and surplus, they have to buy that much and they can buy no more except at the request of the Board It could be doubled at the request of the Board and that would be the limit Six per cent the Board has the right to call for and three per cent has been called for, and they have no choice in the matter That is a relatively minor feature but we might as well mention it because it indicates that no bank can go out and buy Federal Reserve stock for profit, because it has to subscribe a certain amount and it cannot subscribe any more

Secondly, as I have already pointed out, its capital stock is a very minor part of the resources of the Federal Reserve System, but more important than that is the fact that the Federal Reserve Banks are not run for profit, nor run by the banks The banks, to be sure, elect six of the nine directors Three of the directors come from the member banks, three of them come from business, and three are appointed by the Board of Governors, which is appointed by the government The government, therefore, selects one-third of the directors in each reserve bank, it has also the power to remove any director from office No president or vice-president of a bank can be appointed without approval by the Board and the Board has authority to approve their salaries, so you can see that theirs is not the usual power of stockholders and directors over a corporation, a governmental body having full power over the important personnel and over its compensation That is rather important, because if the general public would only understand that no one can be a director or an officer of a Reserve Bank without the approval of the Board of Governors they would see that the private owners of the Federal Reserve System do not have the usual say over the management of the system that a private owner has over a corporation Not only is that the case but it is also the case, as I pointed out a while ago, that all the powers of the Federal Reserve Banks that deal with national problems the supply of currency, the cost and volume of credit, the things that are national in their importance, are all practically in the hands of the Board of Governors, as is also the open market committee of which the Board is a majority.

We have regional Federal Reserve Banks, and on powers of the System relating to national problems, their directors are consultative bodies, they give the Board information about local conditions, they have something to say about lending to this or to that bank, and about the rate at which they will lend, but this rate is subject to "review and determination" by the Board in Washington In other words, they have power over local conditions they can supervise the services, they can see that the banks are properly administered, but they can neither increase nor decrease the assets of the banks and they cannot determine any of the problems as to the volume and cost of money and the amount of currency, which are the national problems It is perfectly proper to say that in so far as the Federal Reserve System has an influence on national affairs its influences are in the hands of a national body and not under private ownership If that were understood it would deprive a good deal of criticism of its vigor because it is not a private organization run for private profit.

The second point I should like to mention is the profit part, which I have intimated but about which I have not gone into detail The Federal Reserve Banks, under the law, if they earn enough, pay six per cent dividends on the capital stock The stock is around one hundred and forty millions of dollars so something like eight and one-half millions of dollars a year are paid in dividends to member banks when it is earned - it need not be paid when it is not earned - and that is a very small amount when you distribute it among seven thousand banks and when you realize that the banks, in addition to the one hundred and forty millions, have some six billions in money on deposit, and so the income that they get on their stock of the Federal Reserve Banks is infinitesimal It may be that a six per cent dividend is not enough I think myself that it is not necessary, but the main point is that it is, in any case, an insignificant matter and that at no time is the Federal Reserve Bank run for the purpose of earning that six per cent, and if the Federal Reserve Banks should make large profits those profits do not go to the member banks because they can never get more than the six per cent

The Federal Reserve Banks made a whole lot of money in 1919 and 1920, not because they went out to make money but because there was a great demand for currency at the time, large member bank indebtedness, and high money rates They paid sixty millions of dollars to the government as franchise tax two years running Since that time the franchise tax has been abolished, but I will discuss that later

The gross earnings of the Federal Reserve System since its beginning have been very substantial, say something over a billion dollars in twenty-two years. Half of that money has been spent on expenses These expenses are very largely for services They are expenses of supplying the country with currency - I mean the printing of money and seeing that it is distributed and that it reaches the banks - and taking in the old money and supplying new paper money That is one of the expenses, and the other big expense is the clearing of checks, which is a big subject that I cannot go into now but which has resulted in the fact that money is the same everywhere and that you do not have to pay exchange if you are in San Francisco and want to make a payment in New York and all that sort of thing The System has speeded up the clearance of checks and reduced the cost of doing business in this country tremendously. The expenses of the business have been in these public services in supplying the country with currency and in supplying it with exchange with checks, in seeing that the checks are cleared and collected at a minimum cost and at a maximum of speed Of the money that has not been spent for expenses, ~ me six hundred million dollars in the twenty-two years, one quarter was paid to the government directly for franchise tax, another quarter went into surplus and was taken over by the Congress of the United States to contribute capital to the Federal Deposit

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Insurance Corporation - in other words, that was taken from the Reserve Banks and put into the Federal Deposit Insurance Corporation, where it serves a public purpose, another fourth was put into surplus, which increases the ability of the Federal Reserve Banks to serve the System by making their resources larger, and which in case of liquidation goes back to the government, so that is also government money. So there are three-fourths of the net earnings of the System that have gone, in one form or another, into public service. Another fourth was paid out in dividends, and those dividends, I repeat, were always fixed by law at six per cent of a small capital and they have not fluctuated up and down in accordance with the profits of business, so that all this talk about the Federal Reserve System being run by private industry for private profit is not in accordance with the facts.

The franchise tax, which is the amount that the System was supposed to contribute to the government (the System had to give the government practically everything it earned above the six per cent) was in effect until about two years ago when it was abolished. This was not done at the request of the System but because Congress thought it was best to permit the Federal Reserve System to rebuild its surplus. Congress took one hundred and forty millions of surplus away from the Federal Reserve System to give it to the Federal Deposit Insurance Corporation and it was decided to let the System rebuild that surplus and, therefore, not have it pay the government anything. Everything the System now earns above expenses and dividends goes into a surplus fund. That fund simply strengthens the System while it lasts and belongs to the government in case of liquidation. Congress, if it chooses, can appropriate it for other purposes. The abolition of the franchise tax was the loss of a good talking point - it was easier for us to talk when we could say that everything the System earned above six per cent went to the government anyway so you do not need to worry about that. That is no longer true, but everything that we earn above six per cent goes into a surplus fund which increases our efficiency and in case of liquidation does go to the government, so this talk about being run for profit is dead wrong. Just one more particular point on that is the fact that because of the management by the government and because of the fact that the profit motive is not in the System, it means that we do not invest all we have in order to make money, nor do we withdraw investments when they become too large. In other words, the reserves in gold in excess of the legal requirement, several billions in excess, show that the Federal Reserve System does not try to make money but regulates the money that is outstanding by its conception of the public interest

About currency more specifically The Federal Reserve Banks do have authority to issue money Theoretically you can say that the Federal Reserve Banks for the cost of printing the money get assets on which somebody pays interest, but I have already explained that the management is not a private management, therefore it is not done for any private profit I have already explained that there is no profit to speak of that any one makes, that any profit that is made goes into the pot for future service

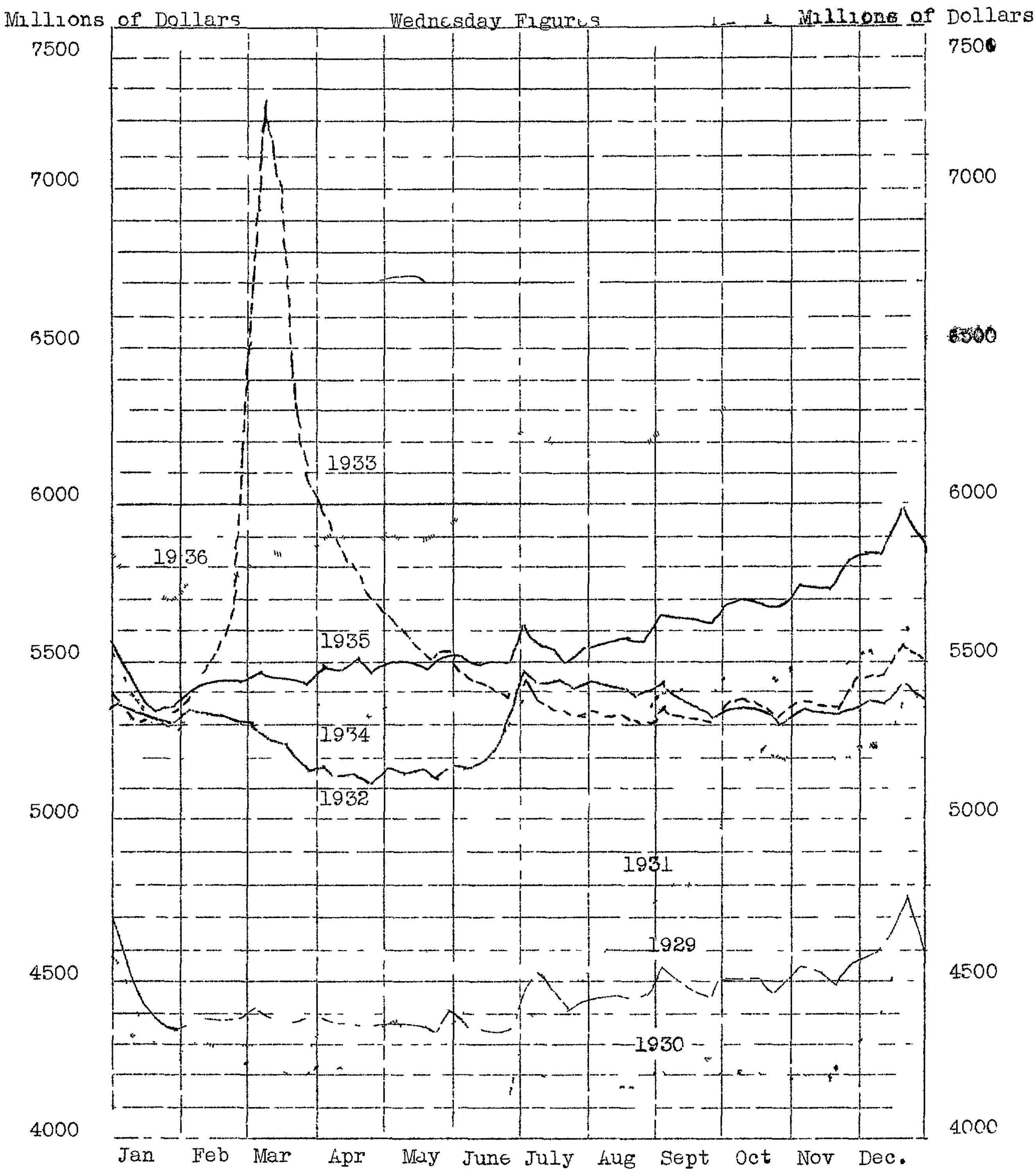
But there is also in connection with currency another important limiting factor• that the Federal Reserve System is not in a position to keep out more money than the public wants The money in this country is elastic When the payrolls and retail trade are high there is a large demand for money, and then the money flows out from the Federal Reserve When the retail trade and employment are low the money flows back into the Federal Reserve Banks, and the Federal Reserve Banks have no way of keeping it out because the public does not keep more money in its pockets just because the Federal Reserve prints more – we keep as much money in our pockets as we have need for, as our habits require. That is, if we are in the habit of paying for our lunch with cash we take out of our pay check as much money in cash as we will likely need until the next pay check The fact that the Federal Reserve has printed more or less is not going to make any of us carry more or less in our pockets The same is true of the department stores They are not going to keep money in their tills in any larger amounts than they need to make change And the same is true of banks The banks are not going to keep any more money than they need because the money in their valuts is a dead asset They will keep the amount for reasonable demand made upon them but they are not going to keep any more, because it is only a risk for robbery, and it results in absolutely no return to them, so they deposit it with the Federal Reserve Bank, and when it is needed again the Federal Reserve sends it out again As a result there is a very definite fluctuation in the amount of money in circulation

This chart (Chart 4) shows the currency in circulation for a number of years Let us take the year 1929 During the spring there is not very much change in money.

Chart 4

MONEY IN CIRCULATION

OUTSIDE TREASURY AND FEDERAL RESERVE BANKS



However, there is a big increase in currency in circulation in July Why do you suppose that is? On the fourth of July people have to have it for firecrackers and other holiday activities. It is a pretty responsive system that results in circulating several hundred millions just because people go away over the holidays and buy fireworks We have the same thing here (indicating) - this is Labor Day - another increase In May we have a little one for Decoration Day, but the big increase of the year happens in December when people get money for Christmas shopping It always goes up at that time and then it goes down after Christmas and the first part of January That is the seasonal fluctuation Then, of course, it fluctuates also over a longer period of time in accordance with the volume of business in the country

In 1929 the country was prosperous, yet you see that it required less than $5,000,000,000 of currency In 1930 currency declined with the reduction in payrolls and trade. Toward the end of that year currency went up abruptly What was the reason? Was it prosperity? No The Bank of the United States and the Bank of Kentucky failed, and people began drawing money from the banks because they were afraid of them, and that resulted in this rise And then it resulted in this enormous growth in 1931 when the banks were failing and people were taking money out It resulted in this phenomenal growth in the crisis of 1933 Just before the new administration came in there was a time when in a short few weeks people took out two billions of money, and the Federal Reserve was in a position to pay it out According to one school of thought we should have been at the peak of prosperity right here (indicating March 1933) but, as everybody knows, that was not the case Then the money began to come down

I might mention now, incidentally, that we still have a lot more money out than we had in prosperous times, the reason being that the money that went into hoarding has not yet found its way back People who have put their money in socks or safety deposit boxes have not yet taken it out to spend it Secondly, there are communities that are not adequately served by banks Thirdly, the banks are increasing their charges for services and that increases the amount of things that we pay for in cash rather than by check And then, of course, on top of it has been business recovery, but judging from this comparison there is probably still a billion dollars or more that is in cash that reflects the hoards still held

The main point I wanted to make is that currency is something with which the Federal Reserve meets the demands of the people It absorbs the money that is surplus and pays out the money when it is demanded It has no way directly to influence the volume of actual cash in circulation, that is, in use at the initiative of the public Therefore, the Federal Reserve Banks are simply more or less a passive mechanism that regulates money by absorbing the surplus or paying it out in a deficiency I think that in the light of this record, and the fact that the Federal Reserve Banks have had to meet the demand for as much as two billions of dollars in the course of a few days and have been able to do it, this particular piece of mechanism is very well set up. I would be very happy, indeed, myself if all the other functions of the System could be performed as effectively and as efficiently and were as simple