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THE ARMY INDUSTRIAL COLLEGE
Washington, D. C.

Course 1937-1938

THE ROLE OF THE FEDERAL RESERVE SYSTEM IN FINANCING A WAR

by

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April 27, 1938

AIC 270 (6/20/38)8

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If we were engaged in war it would not bring about a change in the nature of the Federal Reserve functions so much as in the conditions to which those functions apply

As fiscal agents of the United States Treasury, the Federal Reserve banks would, of course, have to assist with the very great burden of war financing They receive subscriptions to Government issues, allocate the issues to the subscribers, deliver the issues and receive payment They pay interest coupons and maturing obligations and effect exchanges of issues. In time of war, when, presumably, efforts would be made to secure as wide spread a subscription to Government issues as possible, the volume of work involved would be enormous.

In connection with Government financing but not as an activity of the fiscal agency function, the Federal Reserve banks would also have to assist in the financing of the public's purchase of Government obligations.

The function of issuing currency and coin would presumably not be greatly changed by war conditions Any increase in the volume of money in circulation would be readily effected through the utilization of existing machinery. However, since the greater part of the increased demand for means of payment in time of war would be met by the use of bank deposits transferable by check, it is not to be supposed that any very great increase in the volume of money in circulation would occur.

The services of the Federal Reserve banks in facilitating the clearance and collection of checks and the transfer of funds in general would presumably be called on to a greater degree during war time than at present. The increased volume of business incidental to war would entail an increased volume and velocity of payments, but the machinery of the Federal Reserve System is adequate to meet without strain any conceivable increase in the volume of items to be handled

In the field of credit control also the Federal Reserve banks would presumably exercise their normal central banking functions, though possibly more actively than they have been called upon to do in recent years With our present enormous supply of gold, with banks holding vast excess reserves, and with the ready possibility of increasing through central banking action the volume of those reserves, there is no prospect of any difficulty in providing adequate credit for war-time industrial activity. The System has available, as you know, the power to decrease reserve requirements and thereby enlarge very greatly the basis for the extension of credit. It has the power through the purchase of securities in the open market to increase that reserve base still more. It also has the power through discount to enlarge and replenish the reserves of individual banks to the full extent of any conceivable demand

The exact conditions under which the System would be called on to exercise these powers would depend, of course, upon the nature and extent of the war in which we were engaged and upon our relations with our allies I think that I cannot do better than describe to you informally the present structure and functions of the Federal Reserve System and then indicate very briefly the use to which they would be put in war time.

The Federal Reserve System was originally organized for the purpose of decentralizing the currency and credit supply of the country This being a very large country, we deviated somewhat from the central bank idea in Europe. European countries have in most cases one central bank with branches, but here, because of the area we have to cover and because of the variety of economic conditions in the various sections of our country - agricultural, industrial, commercial, financial - we have 12 autonomous Federal Reserve Banks located in 12 different districts The districts, as you will remember, are Boston, New York, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, St Louis, Minneapolis, Kansas City, Dallas, San Francisco. If the area is large there are branches in that area For example, in the San Francisco district, which covers a number of states, there are 5 branches. On the other hand, in the Philadelphia district, which has a small area, there is no branch New York has a branch in Buffalo. Chicago has a branch in Detroit. Altogether there are 25 branches. The branches enable the banks to serve all parts of their districts promptly. Then, to meet special currency demands, 2 agencies were organized, one in Savannah and the other in Havana, Cuba Altogether, therefore, we have 12 Federal Reserve Banks, 25 branches, and 2 agencies.

The Federal Reserve Act provided that there should be a board, known at that time as the Federal Reserve Board, to be appointed by the President of the United States, with the advice and the consent of the United States Senate This board was to have supervisory and coordinating power over the activities of the 12 Federal Reserve Banks, the 25 branches, and the 2 agencies. In process of time the Federal Reserve Board was given additional power in the field of monetary control.

With the Banking Act of 1935 greater power to influence credit conditions was given to the Board in Washington, whose name was then changed to "Board of Governors of the Federal Reserve System." On that board are 7 members, appointed for a period of 14 years, to give them independence of thought and action. The Federal Reserve Banks are not owned by the Government They are owned by the 6300 banks, approximately, which are members of the Federal Reserve System There are altogether about 16,000 banks in the country Less than half, therefore, are members of the System. Yet the 6300 which are members hold about three-fourths of the total assets of all the banks of the country. In other words, the member banks include nearly all the larger banks of the country. Membership in the Federal Reserve System is obligatory on all national banks Each such bank purchases stock in the Federal Reserve Bank of its district, equal to 3% of its own capital and surplus There are also about 1,000 state member banks, that have applied for membership and been admitted to the System. They too have to purchase stock of the Federal Reserve Bank of their district equal to 3% of their capital and surplus Each member bank subscribes for 6%, but only 3% has been called for. The other 3% could be called for if necessary. The member banks receive dividends of 6% per annum cumulative on this stock.

Now there are, as I told you, about 6,300 member banks, about 5,300 of which are national banks and required to be members State banks which become members obtain their charters from the state authorities. In each state we have a state bank supervisor, so that makes 48 banking systems, one in each state Then we have the Comptroller of the Currency, supervising the national banking system, that's 49 There is also the Federal Deposit Insurance Corporation, which came into existence not so long ago. It insures the deposits of its member banks Membership in the Federal Deposit Insurance Corporation is not to be confused with membership in the Federal Reserve System. Every bank that is a member of the Federal Reserve System ipso facto becomes a member of the Federal Deposit Insurance Corporation. But there are a great many state banks which are not members of the Federal Reserve System but are members of the Federal Deposit Insurance Corporation. Then there is also the bank supervisory authority of the Federal Reserve System, which supervises national banks in addition to the supervision they receive from the Comptroller of the Currency, and supervises state member banks in addition to their supervision by state authority. The Federal Deposit Insurance Corporation supervises also those state banks whose deposits are insured.

In addition, there is the Reconstruction Finance Corporation It is not primarily supervisory, but is an organization that lends to banks. It owns preferred stock in many banks and it has power to examine those banks that it has stock in.

There, briefly sketched, is your banking picture - over 16,000 banks scattered all over the country, some national banks and some state banks, some mutual savings banks, others commercial, others trust companies. Then we have, in addition to that, all of those supervising agencies, the states, the Comptroller, the Federal Deposit Insurance Corporation, the Federal Reserve System, and the Reconstruction Finance Corporation You can see that that is a difficult situation. It has just grown up like "Topsy " It will take some while to reconstruct it because it isn't as though you had a clean sheet of paper to write on and say "This is the way it ought to be." You just can't do that

Even though we have the Federal Reserve System, banks continue to have correspondent relations with other banks as well. That means, for example, a bank in Milwaukee will keep part of its reserves with a bank in Chicago A bank in Chicago will deposit part of its reserves with a bank in New York.

The reason for the correspondent relationship is that the smaller banks get certain services from the larger banks. For example, they get advice on their portfolio of securities, or the New York bank may invest some of their funds for them.

There is still another factor that came into the picture recently, the Securities and Exchange Commission We are discussing with them the possibility of their modifying their regulations somewhat, and they have already done so to an extent. We are also suggesting to the Comptroller of the Currency that he modify certain of his regulations Of course it is always presumptuous to suggest something like that to the other fellow, because he can turn around and say, "You have enough to do in your own backyard without coming over here and telling us what to do." We are suggesting that the

Comptroller modify his regulations in respect to the kind of securities that can be purchased by member banks When he says only certain securities can be purchased for the portfolio of the national bank that at once becomes our regulation and applies also to state member banks. If we can we would like to modify those regulations somewhat so as to provide a larger base upon which the banker can choose the kind of securities that he wishes to purchase for his portfolio. It seems to us that this would make capital more easily available. Today if you float an issue you have difficulty getting it on the market. It may be a very sound issue, but the bank can't buy it because it is not marketable, it hasn't the volume, it is not registered, and it is not in the manual Therefore, the banks are obstructed from investing as they otherwise might and that makes it difficult for the smaller fellow to get his capital needs.

We are also discussing adoption of a uniform examination policy. You may have read something of that in the newspapers this morning The idea is to get all of the supervising agencies to adopt a more uniform policy of examination Each of these agencies I have mentioned has power to examine banks, though in practice only one authority goes in to examine a bank. The Comptroller examines the national banks and that is all We receive a copy of his examination report and pay him for it In theory we too can go into the national bank to examine but we don't do it The state member banks are examined by us and the state banks that are not members of the Federal Reserve System but are members of the Federal Deposit Insurance Corporation are examined by the Federal Deposit Insurance Corporation. Whenever one agency goes in to examine, the other agencies stay out, and they merely get a copy of the examination report. Therefore, there isn't the duplication of examination that might be supposed, but there may be differences in the policy of examination What we are trying to do now is to get all of these, the Federal Deposit Insurance Corporation, the Comptroller of the Currency, and the Federal Reserve System, and eventually the bank supervisory agencies of the forty-eight states, to agree upon a more uniform policy of examination, particularly on the question of securities and also on the question of a classification of some of the assets under the column headed "slow." Many loans are made for a longer period than 30, 60, or 90 days, which is the average commercial loan. Many loans are made for 2, 3, 4, or 5 years, and the moment you classify them under the "slow" heading of course it looks like criticism, when, as a matter of fact, the loans may be sound.

In order to have a real expansion in industry, commerce or agriculture one must obtain money for a longer period of time than 30, 60 or 90 days. Those loans ought to stand upon their own merits of soundness rather than upon the time element

With that in mind, the Banking Act of 1935 provided that any sound assets, regardless of maturity or classification, might be discounted by a member bank at its Federal Reserve Bank.

This provided a broader base upon which the Federal Reserve Banks can extend credit to the member banks of the country, so that today, in place of being limited to what was originally designated as eligible paper for discounting purposes, a member bank can borrow on any kind of sound paper with 30, 60 or 90 day maturities or 1 year or 5 or 10 year maturities. Such borrowings must be for 4 months or less and bear a rate of interest one-half of 1% higher than the discount rate of that district. You get a loan, for example, from a bank and the bank needs cash and so it takes your paper over to the Federal Reserve bank, if it is for industrial, commercial or agricultural purposes and it discounts that paper at from 1% to 2%. In other words, if it had 4% or 5% interest, it pays 1% to 2%, it collects the 4% or 5% but it pays part to the Federal Reserve bank. The Federal Reserve bank holds that paper for that bank and gives credit to that bank on the account. The Federal Reserve Banks are lenders of last resort. Their lending powers are practically inexhaustible.

However, banks as a usual thing don't like to borrow from the Federal Reserve bank or anybody else because they don't like to show in their statement that they owe any money to anybody. Therefore, there is very little occasion for the Federal Reserve banks to use their discount powers. When the Federal Reserve bank came into existence in 1914 this was considered to be not only an important power but one to be most frequently exercised. It was presumed that the banks would borrow from the Federal Reserve and we could either supply them with credit or refuse. As a matter of fact, even though that was one of the principal purposes, to discount and lend to banks, the banks have refrained from coming to the Federal Reserve banks except in times of emergency. It would be desirable if we could get bankers to take the point of view that borrowing from the Federal Reserve Bank is a normal and proper procedure when it enables them to meet the legitimate requirements of their customers, but I don't know how we can They seem to feel that borrowing is always objectionable.

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For reserve purposes, there are three different classifications of banks. First are the central reserve city banks. The banks in New York and Chicago are called central reserve city banks, and their rate of requirement of reserves is higher than is the rate for the banks in reserve cities. There are about sixty reserve cities, excluding New York and Chicago Then banks in all other places are called "country" banks, even though they may be in relatively large cities. The rates of required reserves are different for the banks of those three different classifications, the central reserve city banks, the reserve banks, and the country banks. That is, the rate on demand deposits is different. The rate on time deposits is the same in all three classifications.

The requirements as stated in the Federal Reserve Act are 13% for central reserve cities on demand deposits, 10% for reserve cities, 7% for country banks, and 3% on time deposits The Board was given power to double those requirements or raise them to any figure in between While the Board could double the original requirements, it can't go below the 13, 10 and 7 It could go up to twice the amount and then come back to this amount but it couldn't go below that.

The present reserve requirements on demand deposits are for the central reserve city banks 22 3/4%, for reserve city banks, 17½%, for country banks, 12%, and on all time deposits for all classes of banks, 5% I will also give you the figure for excess reserves They enter into this picture very definitely, they are the reserves that the member banks have in the Federal Reserve bank in excess of what they are required to have by law The required reserve is frozen and can't be taken out. The excess reserve is the base upon which we can extend credit in this country It is lying in the Federal Reserve banks idly without paying a penny of interest to the member banks, but when the member banks begin to lend, they lend on it.

Now in war time, as I said at the outset, the regular services of the Federal Reserve banks will be employed, but I find it difficult to say how they will be employed without knowing what the war is. There are certain to be, however, two main lines of credit required one for the Government and one for industry.

With respect to Government financing, the Federal Reserve banks would have a double role to play first, as fiscal agents of the Treasury in handling subscriptions to securities, receipt of payment therefor, and delivery, and second, as a central banking organization, assisting the banks of the country in financing flotations.

With respect to the financing of business, the task of providing ample credit, if conditions were anything like those at present, would not be difficult. The banks of the country have abundant excess reserves. Those reserves could be replenished by purchases of securities in the open market on the part of the Federal Reserve banks. They could be further replenished by rediscount of paper by member banks. They could be still further replenished by a reduction of reserve requirements. The difficulty would not be to supply sufficient credit, but to avoid supplying too much The least of our worries, it seems to me, if we were engaged in war, would be the adequacy of our credit facilities.

Discussion following lecture of Mr. Szymczak

Q. There is a figure you promised us but didn't give, the credit on excess reserves plus the desterilized gold.

A. The amount of excess reserves on April 15, 1938, was $1,700,000,000 and on April 16 when we decreased reserve requirements it became $2,500,000,000. Then after the full desterilization, about which I spoke a moment ago, which will become effective as the bills are retired, there will be $3,900,000,000 total excess reserves.

Q. I would like to ask if the Federal Reserve Board has thought of any plan as to how the Board would operate to control price inflation in war time.

A. Well, it is very difficult for us to control prices. That is one of the things that we reported to the House Banking and Currency Committee when the committee was considering the Patman bill. May I read to you just what we said to them on prices because there are so many things that enter into prices. The Federal Reserve System can only control the supply of credit. Here is what we said to the House Banking and Currency Committee on the 1926 price level, because that provides that we should do whatever we can through our powers given us by Congress to bring the price level of the country back to 1926. This relates to your question and I will tell you what we said:

> "In an amendment the Board of Governors is instructed [by the Patman Act] to raise all-commodity index until full employment of all persons able and willing to work shall have been achieved and until the price level shall at least reach the all-commodity

index of 100, as established by the Department of Labor, for the year 1926. The Board is further directed to maintain this price level with variations not to exceed 2 per cent. To accomplish this the Board is directed to expand and contract demand deposits [That means credit] by engaging in open-market operations.

"The position of the Board of Governors on the problem of monetary objectives was indicated in a statement issued on August 2, 1937, in response to a Congressional inquiry. The Board is in full agreement with the ultimate objective of proposals to promote economic stability, which means the maintenance of a volume of business activity and of national income adequate to assure as full employment of labor and of the productive capacity of the country as can be continuously sustained. The Board is aware that commodity prices are an important element in the Nation's economic life and that violent fluctuations of prices have disastrous effects. It believes, however, that price stability does not necessarily lead to economic stability and, therefore, should not be the principal objective of public policy. In its opinion the objective of economic stability cannot be achieved by monetary means alone, but rather should be sought through coordination of monetary and other major policies of the Government which influence business activity.

"The principal difficulty with a stable price level as the objective of economic policy is that it is not in itself a satisfactory indicator of a continuously smooth working of the economic machine. There have been periods in the past when the price level was stable and nevertheless there were developing numerous maladjustments which led to an economic collapse. For example, from the latter part of 1927 to the latter part of 1929 the index of wholesale prices showed little change, but other developments were threatening economic stability. Prices and activity on the stock market were rising rapidly, and brokers' loans grew at an unprecedented rate. Construction of office and apartment buildings was being promoted with a view to quick profits at a rate that endangered the longer-time outlook in the building industry. Loans were being made for enterprises abroad without careful investigation of credit risks, and business activity in general was increasing, partly as a result of speculative developments, to a level that could not be sustained. The use of the commodity price level as a guide to credit policy in these circumstances would have been entirely unsatisfactory. There is no assurance that it would be satisfactory in the future."

There is much more on that but the point I am trying to make is that we cannot by our monetary powers affect the price level except in cooperation with other agencies of the Government. Then we can, outside our market operations and discounting, also increase or decrease reserve requirements. If prices were high in order to bring them down we would follow the policy of tight money, make credit less available. If prices were low we would increase the excess reserve position of the banks. In general that is what we do but by that action we won't assure any particular price condition; but in conjunction with other Government agencies which come into being in time of war I think that perhaps that could be done.

Q. When the Board of Governors determines that you should go into the open market and buy securities how is that divided among the Federal Reserve Banks?

A. When the Board of Governors meets it meets not alone but with the five presidents of the twelve Federal Reserve Banks. On the Open Market Committee we have the Board of seven - there is one vacancy now and so it is six - and five presidents of the Federal Reserve Banks, a total of twelve. That is the Open Market Committee. We decide to purchase, let's say, five hundred millions of securities in the open market. When we purchase them we then distribute them to the Federal Reserve Banks, depending upon their capital structure, the amount of profits that they require in order to keep operating, and also the agreement of the banks themselves to take less or more as between themselves. There is no particular base; we can change it from time to time as the banks require.

Q. It depends upon the size?

A. In general it is distributed among the banks upon the size of the bank, the larger the bank the more securities it has. But of course the securities never get to the Federal Reserve Banks; they stay in the New York bank.

Q. That is mandatory?

A. Once the Open Market Committee adopts a policy it instructs the New York Bank through its executive committee to buy or sell. The New York Bank buys or sells and then distributes. There is no question as to whether they want it or don't want it. It is there.

Q. What does the Federal Reserve Bank use as an indicator to tell them when to expand and when not to expand credit?

A. In the first place the Federal Reserve Bank itself does not do that. It is done by our Board in Washington and the Open Market Committee. There are really two monetary influences, one the Open Market Committee which consists of the Board of Governors and five presidents of the twelve Federal Reserve Banks, and the other is the Board of Governors. The Board of Governors has power to increase or decrease discount rates in the Federal Reserve Banks. It has power to increase or decrease reserve requirements. It has power to directly warn banks on their credit policies. The Open Market Committee has power to buy or sell in the open market. What we generally do is watch figures of the amount of loans and investments. As the loans and investments go up and keep going up at a high rate and there is a big base of excess reserves which can still be loaned out, that is an indication that there is a potential extension of credit which nears the boom period and then we put on the brakes. We reverse our policy from an easy to a tight money policy. In that case in the open market we would start to sell securities from our portfolio so that the banks and the public would have securities in place of credit or cash. In that case we would increase the discount rate; if it were a marginal we would increase the margin of the amount that can be loaned for the purchase of speculative securities. The other thing was the increase of the reserve requirements and the open market operations. If loans and discounts start going down, banks aren't loaning anything, there is no demand for it, then we can supply the amount of credit that could be loaned by the banks by increasing the excess reserve position. We can merely supply it; that doesn't mean the banks will loan it. It is up to them to loan it. We can't force them to loan. But again, there is no definite procedure that we say that when this happens we do that. As a matter of fact, it is one of the things that you simply have to say: "It looks to us as though this is what we ought to do", and begin to pray. It is not politics; if it were it would be very easy.

Q. If the desterilization is carried to its ultimate conclusion and you get excess reserves of $3,900,000,000, does that place the extension of credit beyond the operations of the Open Market Committee?

A. If we want to go the other way we would have one terrible time. We only have $2,565,000,000 of Government securities, so if we want $2,565,000,000 that wouldn't take up the three billion. Selling the whole portfolio would leave us nothing to sell later. If this three billion goes any higher we have to go to Congress and ask for additional power.

Q. Has there been any noticeable change in loans going out? This maneuver is to force money out of banks now. Has there been any noticeable accomplishment?

A. Not noticeable as yet.

Q. I am interested in just what the purpose was in these maneuvers to increase the amount of excess reserves.

A. The purpose was -- of course we had a time of it. You read our annual report and see why we increased reserve requirements and then read why we decreased reserve requirements; and of course it leaves you in the position in which we found ourselves at the time. (Discussion off the record.)

Colonel Miles: You spoke in the early part of your talk about the necessity for some sort of a unification of banking within the country. I would like to ask, do you think the Federal Reserve banking system has been a step in the direction of securing an element of unification?

A. Yes, very definitely so. It has taken in national and state banks. All state banks may come in now, in accordance with the present law. Always when you talk about unification you step on somebody's toes, somebody who is a state thinker and doesn't want anything moved into Washington.

Colonel Miles: I take it you really believe that more stringent unification would be --

A. You see, it is so easy for England and Canada as they have few banks. Canada I think has 16 banks; the rest are all branches. When they want to do anything they say "Here's what we are going to do." They can extend credit to the banks and therefore adopt a policy very readily, but when you have 16,000 units it is very difficult, especially with each state having its own laws on banking. But you can't talk about a thing of that kind publicly because you step on all the states the moment you do. You have to have a unification if for no other reason than monetary control. There are still excess reserves of the banks that are not members of the System but they are on deposit in the vaults of the bank and with corresponding banks. Part of it will come to us if it is deposited. What if you are not a member of the System but you deposit your money with your banker, with a member of the Federal Reserve System? Part of that will have to go into the required reserves of that bank so we get part of it that way. I think that we are making moves in that direction. It takes time. We are young; in central banking we are young and have much to learn.

Q. This may not be relevant, sir, but at any rate what agendy charters the banks in the District of Columbia?

A. The Comptroller of the Currency.

Q. Then you are back of Mr. A. B. Ginn and his theory?

A. I don't know —

Q. The expansion of banking theory?

A. Yes and no. I would be for branch banking of a kind, different branches of a kind. The unit banks are nothing more than actual branches and so are units that have directors. They are practically the same but this is a form of branch banking that will eventually come into this country and is a subject you can't discuss. The moment you do you have all the independent bankers on your neck. I would say a certain kind of branch banking is necessary, eventually. I think it will take time. But the principal thing before you even discuss that is to unify our own agencies here because how can we talk about it when our own agencies are divided, the Comptroller, the Federal Reserve System, and the Federal Deposit Insurance Corporation?

Colonel Miles: Does that set-up come about because of our desire not to give permanent status to certain positions which are really experimental?

A. The Reconstruction Finance Corporation is an emergency organization. It is to go out of existence in 1939. When the Federal Deposit Insurance Corporation came into existence the bill did provide that on the board of directors should be members of the Federal Reserve Board, but when the bill finally passed they took them off. The Secretary of the Treasury was a member of the R. F. C. and the Federal Reserve but the Banking Act of 1935 took him off. There was supposed to be a sort of dovetailing. The difficulty with an organization of anything of that kind is that once you have established it you have an uphill fight to bring it into something else because every agency naturally wants to have its own independence, its own existence. I think that was due to the fact that insurance was a new thing just starting out. Our experience in the states where we had insurance has not been so very good in certain states. It is a new thing and it was set up that way with three directors. Of course we do work together. We meet constantly with the other agencies.

Q. What is the relation of this buying and selling of securities to the general business of getting money on credit to run the Government on?

A. That's another thing. That is the fiscal operation. When the Government needs money it sells securities. The Government can only obtain money in one of two ways, by taxation or selling securities. Even when it sells securities it must eventually get enough taxes to pay off those securities. It is continually refunding those securities so that perhaps the day would never come when all the securities would be retired and you won't have to worry about that part of it. The Government sells these securities to obtain funds with which to have the Government function. The Federal Reserve System through the open market does not purchase securities from the Government; it cannot under the law, but we can purchase those Government securities and other securities that are within the law in the open market, that means from anybody, a dealer, a banker, a citizen, an individual, from anybody that wants to sell them in the open market. As we buy them we supply credit to the country through the banks. As we sell them we take credit away from the country and supply securities to the country. You see, the one is a fiscal operation of the Government to obtain money by the sale of securities to operate the Government; the other is a monetary to supply credit to the country as a whole, to industry, commerce and agriculture.

Colonel Miles: I think that we are all very much indebted to Mr. Szymczak for this down-to-earth talk. We don't often have speakers come here and give us this type of talk where we really fell that the speaker is speaking down to us. I am sure we all are very grateful for that kind of talk. I have a greater confidence in the Federal Reserve System for having heard Mr. Szymczak.