77

THE ARMY INDUSTRIAL COLLEGE
Washington, D. C.

Course 1939-1940

# THE FEDERAL RESERVE SYSTEM

by

E. A. Goldenweiser
Director of Research and Statistics
Board of Governors of the Federal Reserve System

November 7, 1939

AIC 146 (1/13/40) 10

THE FEDERAL RESERVE SYSTEM

I have met with this group for several years, but they tell me that it is a new group of individuals each time, so that I do not need to be afraid of repeating myself. I do not prepare these lectures particularly and therefore my memory is not good enough to repeat myself if I tried, but I do every year have the problem of gauging my remarks at the right level because I do not know how much you know about finance, maybe you know a great deal and much of what I say may sound elementary to you. On the other hand, things taken for granted by me may seem to you obscure. For these reasons I am going to do my best in meeting your needs and then give you an opportunity to ask such questions as you may wish.

The Federal Reserve System's headquarters are across the street from here, and I suppose some of you have been in there. We have been there for about two and one-half years, before that we were scattered through the city, in the Treasury and various buildings in town. The fact that we have a nice building where the Federal Reserve Board or the Board of Governors of the Federal Reserve System, can be with its entire staff is a great advantage and has this important characteristic over and above purely physical comfort - having a fine building that represents the headquarters of the System has made it easier to indicate to the country and to constituent banks that the Federal Reserve System is an institution primarily under Government supervision and control. When the Board was scattered in a lot of rented quarters it was more difficult to carry out the impression that it is primarily a governmental institution.

The Federal Reserve System was organized just about twenty-five years ago. Twenty-five years ago on the 23rd of December, 1913, the Act was signed, and a year ago, last December, we celebrated the twenty-fifth anniversary of the signing of the Act. This week many banks are celebrating the twenty-fifth anniversary since the banks actually opened their doors, around November 16, 1914. They have a quarter of a century of history behind them. That is not a long period when compared with the central banks of most European countries. I told last year and might tell again an incident which occurred when I was in England in 1938. I was having lunch at the Bank of England and Governor Norman picked up a piece of silver and showed me that it was dated 1694, and he said that this was the year when the bank was established, they made it a custom that whenever they bought any silver they shopped around to find silver made in that year. That is a typically British sentiment: they do not hurry, they take their time to find silver made in a certain year. What impressed me more, however, was the fact that they had been operating two hundred and fifty years as compared with us who think ourselves adult with an existence of only twenty-five years.

Since we have been in existence we have been constantly under the influence of extraordinary times. We started at the time when the World War started. After a while, the United States joined and the Federal Reserve System had to help finance the war. The expansion which occurred was followed by reaction and the Federal Reserve had to serve the double purpose of curbing the reaction and taking the blame. One of its functions is to take the blame, because nearly always it has to act contrary to the trend. If the trend is upward and the Federal Reserve System finds it has to do something to restrain it because it is going upward too fast, it is blamed. If things are going badly and the System tries to turn them up, it is criticized for encouraging inflation. It is always the butt of criticism.

The need for the Federal Reserve System was felt very definitely in this country. We had at the time of its establishment a very scattered banking situation. We had several thousand national banks and thousands more of State banks that were not chartered by the National Government, but chartered by State governments. There was no unifying principle. When the demand for currency and credit became acute in the autumn, for instance, at the time when crops are being moved and autumn trade is lively, if that happened to come at a year when there was an unusual amount of activity, the result would be a shortage of currency and credit. Bank reserves were scattered all over the country with an arrangement by which country banks were permitted to hold part of their reserves in banks in reserve cities, of which there were about fifty, and the banks in those cities in turn were permitted to hold half of their reserves at a central reserve city bank and banks in New York City, together with banks in Chicago and St. Louis, had to hold their reserves in cash. When the demand for money would become acute, the country banks would draw the money from their city correspondents, and the correspondents in turn would draw it from their central reserve city correspondents, and the whole demand would converge on New York. New York, in turn, would find itself strapped for funds and periodically it would have to close the doors of the banks temporarily, currency would go to a premium and there would be a panic. The amount of currency was very rigid because national bank notes could be issued only to cover certain kinds of Government securites of which there was a fixed amount in existence. There was no way of increasing the amount of currency, when the demand was more than usual there was no way of meeting it. That, in a very brief way, refers to the past, pre-Federal Reserve conditions, indicating why the System had to be organized.

The need for some central banking institution exists in every country, it makes it possible to manage the country's finances on a unified basis. When there was no Federal Reserve System, the big banks in New York had to try to do the job, but, not being unified and not having elasticity, they were handicapped. They were not official public institutions, they were primarily money making institutions functioning for their own profit, therefore, they were not in the same position to come to the assistance of country banks as is the Federal Reserve.

Out of the panic of 1907 came the National Monetary Commission headed by Senator Aldrich. The Commission studied the situation for a long time and made a report recommending the establishment of a central bank. The Commission was largely Republican and recommended a central bank controlled by bankers. Just about that time, in 1912, the Democrats came into power with President Wilson, and one of the items on their platform was that they did not want a central bank managed by bankers - no money monopoly - no control by big financial institutions - so that when Senator Glass, at that time a Representative, started to formulate the Federal Reserve Act, while he accepted a good many of the Monetary Commission's suggestions in the way of technical details and organization, he changed the management and the general plan of the System in that he reduced the importance of the banks in the management and increased the power of the Government. He organized the System on the basis of twelve Federal Reserve banks in twelve leading cities with districts surrounding those cities that would use each local bank, and with a governing Board in Washington that is supposed to supervise it.

All the national banks in the country which get their charters from the Federal Government, must belong to the System, and must subscribe 6 per cent of their own capital and surplus to the capital of the Reserve System, 3 per cent has been paid in and 3 per cent is subject to call, but it has not been and probably never will be called. Banks with State charters were allowed to belong if they chose to and if they were eligible under the capital requirements and if the nature of their business was such and their condition and management such that they made the Federal Reserve bank and the Board willing to accept them into membership. The Federal Reserve started with some eight or nine thousand banks owning its stock. These banks technically own the Federal Reserve banks. The expenses of the Federal Reserve banks are met out of their own earnings and they in turn support the Board which gets no appropriations from Congress. The situation therefore is that the stock is owned by private bankers. That has been a source of a great deal of criticism. In Canada the same situation arose on that issue and the government took over the central bank. In most European countries, stock in central banks is still owned by private persons, but in Europe there has been an evolution - existing banks developed into central banks, while the stock continued to be held in a traditional manner.

I want to emphasize the fact that ownership by private banks does not make the Federal Reserve banks private institutions The stock represents an investment by banks that is involuntary. They have to subscribe, if they belong, a given proportion of their own capital and surplus. No more, no less. They cannot sell the stock except by getting out of the System and, if they are national banks, without forfeiting their national charters. They can do nothing with it. They get no more than a certain amount, they have no interest in anything the System makes above the amount. The surplus remains in the Federal Reserve System to be used for public service and if the Federal Reserve banks are ever liquidated it has to be turned over to Congress. Congress considers that it has the right to dispose of the surplus, as it did when it appropriated $140,000,000 of this surplus as capital for the Federal Deposit Insurance Corporation. The ownership of the stock is a very different kind of ownership - more in the nature of a compulsory contribution to capital of the Federal Reserve rather than stockholding in the more usual sense.

The Federal Reserve banks are managed by nine directors of whom six are elected by member banks and three by the Board. This chart shows the Federal Reserve System organization with reference to the principal instruments of credit policy. Here are members, 6,250 member banks. There are three groups in each district - large banks, small ones, and medium sized ones. Each group elects one Class A and one Class B director. Class A directors are bankers, Class B - non-bankers, business men, etc., and these six directors are elected by these groups of the member banks. One Class A and one Class B, each, representing - the large, small and medium banks. The other directors, so-called public directors, are appointed by the Board.

Two-thirds of the nine directors are selected by member banks - three member bankers and three business men not bankers, but this two-thirds control by representatives of member banks is modified by a number of considerations.

The president and first vice-president are selected by the Board in Washington and their salaries must be approved by the Board. The Board has the right to remove any director or officer for cause. That shows supervision and control very much greater than would be present in private corporations, indicating again that the government has a great deal to say about the management of the Federal Reserve System.

This chart is organized to show the five principal instruments of credit policy. It indicates how and who determines these policies.

The five instruments that we have listed here consist of two minor ones and three major ones. The Board has the right to determine the maximum interest rates on time deposits. Margin requirements are prescribed by the Board which tells brokers and bankers and other lenders how much money they can lend on a given security, how much you can borrow and how much you have to have in cash in order to buy this security. During the period when stock prices were going up, the margin was $55. You could not buy $100 securities unless you had $55 in cash. When business got to be worse and there seemed to be no speculative activity, there was a reduction in margin to $40. If you have $40 you can borrow the additional $60. This is entirely in the hands of the Board.

It also determines reserve requirements. Reserve requirements are a unique institution in this country by which every bank is obliged to keep as reserves a set percentage of the money it has on deposit. In all countries banks must keep reserves, but no other country has prescribed the percentage. In this country, the percentages as given by law are 3 per cent against time deposits, 7, 10, and 13 per cent against net demand deposits, depending on location - 7 per cent in country banks, 10 per cent in about sixty cities that are now known as reserve cities and 13 per cent in the two central reserve cities, New York and Chicago. The Board was given the power to change these percentages, to increase them up to doubling them, but not to reduce them below the amount that is indicated by law. Instead of 13, for example, they might have to keep 26 per cent - no more than double, however.

When foreign capital was moved into this country, the gold moved to this country in large amounts and the Federal Reserve System's control of expansion and contraction of credit became ineffective - because banks could greatly expand credit without resorting to the Federal Reserve banks for assistance. The Federal Reserve Board doubled the reserve requirements so that they became 6 per cent, 14 per cent, 20 per cent, and 26 per cent. Then, in the spring of 1938, when business conditions became very bad, the requirements were reduced to about 175 per cent of the statutory requirements, leaving a margin of 1/7 by which the Board can raise them in the future.

These powers are entirely in the hands of the Board. Two other instruments of credit policy are shared by the Board with other agencies. The discount rates at which member banks can borrow from the Federal Reserve banks are one of these instruments. They are established by the directors of the Federal Reserve Banks. They establish them but they have to be "reviewed and determined", as the law says, by the Board. The Board has the power to determine them as well as review them under the rules of the Attorney General, that means the Board can establish the rates if it so wishes, but normally they are established by the banks and approved by the Board. This is one of the joint powers, one of the powers that is not absolutely clearly defined. At the present time the rate is 1 per cent at most of the Federal Reserve banks.

Another power is open-market operations. What that means is this the Federal Reserve banks can buy or sell securities in the open market. Most of the securities are of the United States Government, though municipal securities and some others are eligible. When a Federal Reserve bank buys Government securities it pays by check to the individual, a cashier's check on the Federal Reserve bank. The individual deposits it at his own member bank and the member bank deposits it at the Federal Reserve Bank. The proceeds of that sale become a part of the member bank's reserve. The only thing that counts as reserve under present laws is deposits with the Federal Reserve bank. When a Federal Reserve bank buys a security it is increasing the reserve of the member bank. When it sells it reduces the reserve. Open-market operations are means for increasing or diminishing the reserves of member banks, and since reserves determine the amount of lending a member bank can do, that is a great power. Open-market operations are under the control of the Federal Open Market Committee. This Committee consists of the seven members of the Board and five representatives of member banks

13

who are elected regionally. The banks, therefore, have a certain say about the open-market operations but the majority is in the hands of the Board and the minority is in the hands of the banks whose representatives are presidents of the banks, appointed by the Board. When the Board is unanimous it can have its way, but if the Board is not unanimous, while the bank representatives are, a majority of the Board can be outvoted in the committee.

This gives you a bird's eye view as to who determines credit policies. Three powers are completely in the hands of the Board, one power is mixed, the fifth, the open market power, is in the hands of a committee in which the Board constitutes a majority. This chart is supposed primarily to show the organization and who makes the decisions.

We have had for a long time a low level of interest rates because there has been such a large amount of gold coming into this country from Europe, as I mentioned a while ago. The Federal Reserve System was accused by bankers of inaugurating an "easy money" policy. They think they should have high rates for their money, they sell money and like to get a good price for it. There is a good deal to be said about that. As a matter of fact, banks often make up in volume of operations for what they lose in interest rates. In the second place they have not really a good excuse for kicking about getting low rates for the money they use, since they do not use all the money they have. There are five billion dollars of excess reserves. Greater ingenuity on the part of the banks might result in doing better, but they are not doing so badly at that. This chart is of member bank reserve balances - represented by this line - it shows that the reserves were not built up by open market operations. Since 1934 open market holdings of the Federal Reserve banks have been constant, and if we have a very easy money situation and low interest rates it is due to world conditions which resulted in an inflow of gold. Our gold stock of four billion dollars in 1934 was revalued to seven billion dollars at that time. Since then it has increased from seven to seventeen billion dollars as a result of world conditions, over which the Federal System has no control. So long as that much gold is coming in, the Federal Reserve System is not in a position to tighten money if it should choose to do so. As a matter of fact, business is still at a relatively low level and there is a large volume of unemployment and unused capital, so that the System has no occasion to tighten money. If business were functioning to capacity, then there would be the question of what the Federal Reserve could do to control inflation; so long as this gold is coming in, and so long as banks have enormous amounts of reserves which enable them to function without reference to the Federal Reserve bank, the policy of the Federal Reserve banks is not so much addressed to controlling speculation or to influencing the amount of reserves. There are excess reserves of over five billion dollars with only a limited amount of power to reduce them. Two billion or two and one-half billions of excess reserves are all that the Federal Reserve System can absorb. That is going to be a problem if the time ever comes when business shows an inflationary trend.

I have brought a chart that shows the yield of Government securities. When the war broke out this autumn, Government securities went down very precipitously because people began to think the Government would have to borrow a lot more money. They did not know what the War Department was going to do. Four hundred million dollars worth of United States securities were bought by the Federal Reserve banks in order to prevent Government securities from being swept down by speculative developments. That stopped the decline, they have since recovered about half of the decline. The trend has been the same in corporate bonds, by influencing the course of long-term Government bonds, the Federal Reserve System is influencing the entire capital market. While we do not have a good control of the money situation, we use our power to some extent to maintain orderly conditions in the Government securities market. This is important not only because it is the market for Government credit but also because it has a big influence on corporate bonds and, indirectly, on all financing for purposes of capital formation which is essential for carrying on of business. So we have a rather new field of activity, a more direct responsibility for the behavior of certain types of securities rather than the general behavior of banks in lending money. We have little influence on credit through reserve requirements but we can have an influence on the level of security prices, Government securities and other bond prices.

This does not mean that we can fix prices at which Government securities should be sold. At a time when reserves become less plentiful and the rate of interest goes up, Government securities must go down. It is not the duty nor does it lie within the power of the Federal Reserve System to peg the rate but the System feels that it should prevent violent fluctuations in Government security prices arising out of activities of speculators.

With gold amounting to seventeen billion dollars the question arises whether the Federal Reserve System will ever be in a position to control credit conditions as it was supposed to control them under the law, and I think that with these conditions and with the fact that the Treasury has great powers over credit, the Federal Reserve is not in a position to discharge its normal responsibilities unless the law is modified. I do not know just how we will come out on that but, if business ever gets under way to the extent of employing our resources to full capacity, the problem will be one of either giving the Board the power to control these reserves, or else they will have to have the power to control the assets and activities of the banks. The latter would mean interference with private operation of the banks, or else the Government would have to have control of wages, prices, and everything else, which would mean to depart from our system of private enterprise. Another alternative would be to let nature take its course and be prepared to take the consequences, which might involve a social revolution before we were through.

What I am trying to get at is that the facts should be thoroughly known to Congress and they should take their choice - whether to increase the power of the Federal Reserve System or to create some new authority. The Board called this matter to the attention of the Congress, Senator Wagner introduced a resolution which passed authorizing the committee to make a survey of all these [illegible] is to be taken up in a hearing in the Senate. Probably after the new session some methods of handling the situation will be developed.

We have at this time a business situation which is reasonably gratifying. Business started going up last spring and by August had gone up by a substantial amount. The index of the physical volume of production went from 92 to 102, a pretty good rise. Then came the war and in anticipation of war orders and expectations, both domestic and foreign, there was a great demand for American goods. With an underlying belief that the embargo would be repealed, American business men began to scramble for raw materials in order to be prepared for the demand upon them and the business index went up to 110 in September, 120 in October, and still higher later. The question is - is the rise permanent, or is it likely to be followed by recession? We do not know, but we are inclined to think that since many of these orders are in excess of current demands there will be some recession. Business men have built up an inventory that they will want to dispose of. So long as prices have not shot up fast and labor has not increased its demands, however, with new orders coming in now to justify expectations, the recession may be moderate.

To employ all employables our index of industrial production ought to be 150. The average for 1923 to 1925 is 100. Since that time we have had a great advance in population, and a great deal of technological improvement, so that full employment would necessitate output considerably higher than anything you have seen. We are not likely to have an inflation on a very large scale until after business is going at full capacity, but we can have what is sometimes known as a "spotty inflation" - a great many unemployed and unused capacity in some industries and great demand in other industries. This is not as serious as a full-fledged inflation. Our aim should be to make business go on further and use up all the slack in human and material resources, keeping an eye on the possible necessity of control if things get up to a point where capacity can no longer be increased. Further demand at that stage results in an increase in prices which results in diminishing buying power of every person who has a bank account or insurance policy or fixed income of any sort. That is a situation we do not like to contemplate and which we hope to avoid.

The war has given a stimulus to our business. It may turn out to have been, from a hardboiled point of view, a desirable stimulus, but it is not likely to cure the fundamental problems in our economy. It might result in a great maladjustment as the other war did.

The objective of monetary policy is the same as that of the Government as a whole - to maintain economic stability, to improve conditions for all the people in the country. In the last sentence of his dedicatory speech, the President dedicated the Federal Reserve Building to progress toward an America in which every worker can supply his family with an ever-increasing standard of comfort. It seems to me that is the general policy of the Board, and if that can be successfully accomplished then we have met the fundamental test of serving the people in the way the System and the Board should serve them.