FEDERAL RESERVE BANKS

HOW THE SYSTEM DOES FOR BANKS WHAT THE BANKS DO FOR CUSTOMERS

THE passing by the United States senate the other day of a joint resolution (S. J. Res. 238) authorizing the Federal Reserve bank of St. Louis to erect a building to cost $400,000 for its branch bank at Little Rock, Ark., brought out in debate the fact that the Arkansas bank had loaned $388,000,000 in the years 1919-21 and had made net profits of $1,011,000. These federal reserve banks are going up all over the country—a fact which shows the magnitude and importance of the system. In response to a public demand for information about the Federal Reserve Banking system and its operations the following official statement is presented:

A federal reserve bank does for banks almost exactly what banks do for their customers. It receives money on deposit from such banks as have become members of the Federal Reserve system, and lends to them. All national banks are members of the Federal Reserve system, and many state banks and trust companies have become members also. Every member bank is obliged by law to keep with its federal reserve bank an amount of money which bears a certain proportion to the deposits it has received from its customers. This is called a "reserve," and as the federal reserve banks keep the reserves of their members they are called "reserve" banks. At times, member banks borrow from their federal reserve bank just as individuals borrow from their own bank. Individuals cannot deposit money with a federal reserve bank, or borrow from it; their relation with it is through the member banks.

Before the Federal Reserve system was in operation, each individual bank stood virtually alone. This was safe enough as long as things went well in the business world, but even then the machinery of banking was so cumbersome that it often worked badly.

In order to meet the requirements of law and to pay depositors, all banks used to keep large amounts of gold and currency on hand and most of them also kept money on deposit with other banks in the larger cities. When all went well, the money on deposit with the city banks could be withdrawn in currency whenever it was wanted. But when, as sometimes happened, business or banking conditions were disturbed and suspicion was in the air, the banks were anxious to increase the amount of cash on hand lest an unusual number of depositors might want to withdraw their money. And it was at those times that the city banks were least able to furnish cash. For the available supply of currency was limited, and there was no quick way of increasing it.

The limited supply of currency led to the panic of 1907. For, moved by apprehension, almost every one of the twenty-four thousand banks sought, for its own protection, to withdraw such currency as it could from other banks and pay out as little as possible to its depositors. Though emergency measures were finally taken, they were too late to prevent the coming of trouble, and the existing banking machinery fell apart into thousands of separate units.

Each bank had to trust largely to its own cash resources, because, however willing, the other banks felt they could not give up much of their cash, for by doing so they might impair their ability to meet the possible needs of their own customers. Each bank, in seeking to protect itself, necessarily weakened the entire banking structure. The defenses were weakest when the danger was greatest.

The result was that every few years a money panic occurred, bringing disaster and depression. These money panics from which the United States suffered, and which the organization of the Federal Reserve system now prevents, were, of course, quite different from the commercial crises from which every country occasionally suffers.

Under the Federal Reserve system there is a quick, certain, automatic way by which the banks that are members of the system help one another, in good times and bad. This is important to every business man, every farmer, every working man, every citizen. It is the result of organization—the kind of organization that makes a system of reservoirs in a community better than many separate wells.

It is appropriate to think of the Federal Reserve system as exactly that—a system of reservoirs. There are twelve of these reservoirs, the federal reserve banks of Boston, New York, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, St. Louis, Minneapolis, Kansas City, Dallas and San Francisco—each serving the needs of the member banks in its own federal reserve district. In each of these reservoirs credit is stored up, and from it, as the need arises, credit is supplied to the member banks and through them to their customers, including not only business men and farmers, but other banks as well. The process is much like the storing up of water in a city reservoir, from which it is supplied to houses and their occupants.

It may be thought strange that such a thing as credit, which in this sense is the power to make loans, can be stored up. But the fact is, a great deal of it is stored up in the federal reserve reservoirs. For, as we have seen, the member banks deposit in the Federal Reserve banks most of the gold they formerly kept in their own vaults and some of the money they used to keep on deposit with other banks. And it is the gold which federal reserve banks require in this and other ways that gives them the ability to make loans and issue currency.

The provisions of the law are such that the federal reserve banks can make loans to an amount between two and three times as much as the gold they have. So, having a supply of gold in storage, they have a lending power in storage also. As this lending power is used, the level in the reservoirs falls. In 1920 the reservoirs ran very low, because the farmers and business men made unusually heavy demands upon them at a time when they had already been drawn down by the war needs of the government.

The supply of water in a reservoir becomes useful when it is distributed through the water-mains. The supply of credit in a federal reserve reservoir becomes useful when it is distributed through the member banks. But just as it is the individual and not the reservoir that draws the water, so it is the business man or the farmer who takes the first step which may result in drawing upon the reservoir of credit.

For example:

A grocer in Austin, Texas, wishes to buy fifty barrels of flour. He has not enough money in the bank with which to pay for it so he asks his local Austin bank for a loan. This is the first step just referred to.

The Austin bank, satisfied with the grocer's credit, makes him a ninety-day loan on his note. The grocer buys the flour, and proceeds to sell it barrel by barrel to his customers. As his customers pay their bills, the grocer accumulates money with which he pays off his note.

In ordinary times and in slack seasons, a bank's own resources are sufficient for its customers' needs. But perhaps the Austin bank, which is a member of the Federal Reserve system, is asked to make the loan to the grocer at a time when many people are asking for loans to carry on their business. Or perhaps its depositors for one reason or another are having to draw down their deposits. If the Austin bank is to continue to lend money and pay its depositors, it in turn will have to borrow.

Before the Federal Reserve system was in operation, the Austin bank would have had to ask for a loan from some larger bank with which it had an account. Ordinarily the loan could be obtained. But if money happened to be scarce the larger bank might be compelled to refuse to lend, because its own resources were running below what it might need to meet all the demands of its customers.

Now, however, as a member of the Federal Reserve system, the Austin bank is in a quite different position. It has a bank of its own, the Federal Reserve bank of Dallas, to which it goes as a matter of right given it by law. It sends to the Federal Reserve bank of Dallas the grocer's note and other notes upon which it has already made loans. With these as security, the Austin bank asks the federal reserve bank for a loan.

This is the second step in drawing upon the reservoir of credit, and follows the first step which the individual took when he borrowed from his bank. Both steps must be taken before the federal reserve bank lends a dollar.

The Dallas Federal Reserve bank examines the notes to see whether they are sound and acceptable, and of the kind the law permits it to lend upon. Being satisfied, it makes the loan to the Austin member bank. This is called "rediscounting"; and the rate of interest the federal reserve bank charges is called the "discount rate." This is a published rate, applying uniformly to all member banks in its district, and is often quite different from the rate the member bank charges its own customers. The rate a member bank charges its customers is determined, subject to state law, largely by local business conditions and local banking custom.

Later, when the grocer's note falls due, the federal reserve bank sends it back to the Austin member bank and receives payment for it. The Austin bank in turn receives payment from the grocer and gives him back his note. Thus the circle is completed. Meanwhile, the grocer has been able to carry on his business.

The simple transaction of the Austin grocer is typical of the vast mass of loans which enter into the operations of the Federal Reserve system. Suppose, for instance, that instead of the grocer, the borrower is a dry goods merchant in Butte, a hardware dealer in Chicago, a steel maker in Birmingham, a lumberman in Seattle or an exporter in New York—each a responsible business man in good financial standing locally.

Suppose, again, that the borrower is anyone who owns a United States government bond or note, and puts it up at his bank as security for a loan. Such borrowings from member banks, whether large or small, can be borrowed upon by the member banks at their federal reserve banks if they are within ninety days of falling due. It was loans of this sort, rediscounted at the federal reserve banks, that enabled millions of people throughout the United States to subscribe to the Liberty and Victory loans.

Just such reasons as prompted the Austin member bank to borrow from its federal reserve bank, sometimes cause a federal reserve bank to borrow. Borrowings by many member banks, representing loans that they have already made to their customers, sometimes draw down the reservoir to such a point that it must be replenished if the federal reserve bank is to continue to lend.

This country is so vast that one section of it is apt to have credit to spare when another section needs credit. All that is necessary is a quick and easy means for bringing them together. The Federal Reserve system furnishes the means and has often used it. A federal reserve bank renews its power to lend by borrowing from another federal reserve bank in a district where the demand for credit is smaller. It puts up as security the notes upon which it has lent to its member banks. In other words, one of the twelve reservoirs in the country-wide system pipes in some of the surplus credit from one or more of the other reservoirs and so renews its power to lend.

This is the kind of beneficial co-operation between agricultural and industrial districts that actually took place in the difficult years of 1920 and 1921. At times, when agricultural districts such as Richmond, Atlanta, St. Louis, Minneapolis, Kansas City or Dallas, having received large amounts of money in payment for their crops, had surplus credit, they lent it to industrial districts which were in need of it. At other times, when the situation changed and industrial districts such as Cleveland, Boston, New York or Philadelphia, having received payment for goods, had surplus credit, they lent it to agricultural districts.

Very closely connected with the power of the federal reserve banks to lend is their power to issue currency—federal reserve notes. The power to lend, taken by itself, would be of far less value if the power to issue currency did not go with it. Just as the customer who makes a loan at his bank may need to draw out part or all of it in currency, so a member bank in making a loan at a federal reserve bank may need to draw out part or all of it in currency. The power to issue currency insures to everyone who has a deposit in a solvent bank the ability to draw it out in currency. That explains why this country never again need have a money panic such as that of 1907; explains, indeed, why there was no suggestion of a money panic in the difficult months of 1920.

Look at a five-dollar bill bearing the portrait of Lincoln. On its face it says that it is an obligation of the United States; on its back that it is redeemable in gold at the treasury in Washington. Federal reserve notes are also redeemed in gold at any federal reserve bank.

Each federal reserve bank is required by law to set aside security, dollar for dollar, against the notes it issues. The security may be either gold, or borrowers' paper very shortly to be paid, representing either loans for the production or distribution of goods and farm products, or loans to holders of the United States government securities. The gold which the law requires a federal reserve bank to maintain as a reserve against its notes must always be at least forty per cent of the amount of its notes in circulation.

These notes get into circulation and pass out of circulation in much the same way as money is drawn out of a bank and returned to it.

When a man needs currency he draws a check on his bank and cashes it. If he has not enough money in the bank to meet the check, he may have to make a loan. In just the same way, when a member bank needs currency, it draws and cashes a check on its federal reserve bank. Perhaps the member bank had to borrow at the federal reserve bank for this very purpose. That is how the total amount of currency in circulation increases.

On the other hand, when a man has more currency than he needs he deposits it at his bank and perhaps pays off a loan with it. Just so does a member bank at the federal reserve bank. That is how the total amount of currency in circulation decreases. As federal reserve notes for which there is no demand accumulate in a federal reserve bank, they are either destroyed or put away in its vaults until some need calls them out again.

Whether the volume of federal reserve notes in circulation increases or decreases depends not upon the initiative of the federal reserve banks but upon the needs of the member banks. Their needs, in turn, are decided by the needs of their customers. As in drawing water from a reservoir, it is the individual who takes the first step.

The plan of organization which the law lays down for the Federal Reserve system does two things. It provides a nation-wide system so knit together that nation-wide resources may work as a unit in a national emergency, or be mobilized to meet a local emergency too severe for local resources to cope with. It also preserves the right of local self-government in banking. These are principles with which Americans are familiar in the working of the federal and state governments under the Constitution.

The country is divided into twelve districts, each with a federal reserve bank. In many districts the federal reserve banks have one or more branches for the better service of the member banks. Each federal reserve bank has its own stockholders, directors, officers and clerks like other banking institutions. The stockholders are the member banks. Its nine directors are residents of the district, some from the cities and some from the country. Three are appointed by the federal reserve board in Washington, and the other six are elected by the member banks, each having one vote. In voting, the banks are divided into three groups, each of which elects two directors. These groups are composed, respectively, of the smallest banks, the middle-sized banks, and the largest banks. Only three of the directors can be officers or directors of other banks. At least three, and usually a majority, are representative of industry, commerce and agriculture. For these are the interests which, through the member banks, the system is intended particularly to serve and protect.

These men are responsible for the management and control of the federal reserve bank. They elect its officers, determine the policies under which it operates, and establish, subject to approval by the federal reserve board, the rate of discount it charges. All profits, after setting aside the surplus provided in the law and after paying the member banks six per cent dividends on their stock, go to the United States treasury and are used to reduce the national debt.

The co-ordinating body is the federal reserve board in Washington, which is made up of seven members—five who are appointed by the President and devote their entire time to the work, together with the secretary of the treasury and the comptroller of the currency.

The federal reserve board, however, is not an operating body. Except for its power to require one federal reserve bank to lend to another federal reserve bank, its powers are almost entirely supervisory. But the board does not pass upon the individual loans which a federal reserve bank makes to a member bank. The board itself, of course, cannot lend money because it has none to lend.

In their right to borrow at a federal reserve bank all member banks, large or small, are equal. The law says that a federal reserve bank shall make each member bank such loans as may be safely and reasonably made.

The Federal Reserve system provides the entire country with a currency responsive to its varying needs, and thus removes the danger of a money panic. Moreover, it provides the entire country with a great reservoir of credit from which farm and range, forest and mine, factory and store, may receive assistance in producing and marketing all the innumerable goods and wares which go to make up American commerce, industry and agriculture.

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