The Federal Reserve System After Fifty Years*

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Again it is a great pleasure for us in the Federal Reserve System to meet with the members of the New Jersey Bankers Association and to share our thoughts on matters of mutual interest.

Monday of this week marked the fiftieth anniversary of the incorporation of the Federal Reserve Bank of Philadelphia and the Federal Reserve Bank of New York. Your organization, the New Jersey Bankers Association, antedates us by more than a decade.[1] Despite our comparative youth, attainment of the half-century mark is an important event for the Federal Reserve System and, indeed, I think it is for the United States.

ENACTMENT OF FEDERAL RESERVE ACT

The Federal Reserve came into being because of adversity. Following the panic of 1907, as is well known, the Congress created a National Monetary Commission to investigate the country's banking system and to recommend legislation. The Commission recommended the establishment of a single institution to perform the central banking functions of the country. This proposal gave way to the idea of the present regional system of Reserve Banks combined with a Government board in Washington. The Federal Reserve Act, embodying this plan, was signed by President Wilson on December 23, 1913, and the Federal Reserve Banks opened for business the following year.

ELASTIC CURRENCY. The purpose of the Act, as stated in its title, was "To provide for the establishment of Federal reserve banks, to furnish an elastic currency, to afford means of rediscounting commercial paper, to establish a more effective supervision of banking in the United States, and for other purposes".

All national banks were then, as now, members of the Federal Reserve System. State banks meeting certain standards could become members, and many did, of course. Every member bank was required to maintain certain reserves in its Reserve Bank. The amount of required reserves was a stated percentage of the deposits on the books of the member bank. As banks made loans and created additional deposits in the banking system, required reserves also rose. A bank could get additional reserves by borrowing from the Federal Reserve Bank against the pledge of its customers' promissory notes.

Federal Reserve notes, which were obligations of the United States issued by the Federal Reserve Banks, became the dominant currency of the nation. Member banks could freely exchange their reserve balances at the Reserve Banks for Federal Reserve notes. For example, when the bank's depositors wished to withdraw cash, the bank could draw on its reserve account at the Reserve Bank to get Federal Reserve notes; if it needed to replenish its reserve account, it could do so by borrowing on its customers' paper. The establishment of the Federal Reserve System provided the desired elasticity in the supply of currency and did away with recurrent money panics. That was a great accomplishment; today we take it for granted.

EVOLUTIONARY ASPECTS OF FEDERAL RESERVE

The Federal Reserve System is a living organism built on the banking and credit structure as it existed fifty years ago, and as it has been modified in the light of developments, needs, and experience over half a century. In his inaugural address on March 4, 1913, President Wilson said:

* An address before the sixty-first annual convention of the New Jersey Bankers Association, Atlantic City, New Jersey, May 21, 1964.

[1] The Association was organized January 10, 1903.

> We shall deal with our economic system as it is and as it may be modified, not as it might be if we had a clean sheet of paper to write upon; and step by step we shall make it what it should be, in the spirit of those who question their own wisdom and seek counsel and knowledge, not shallow self-satisfaction or the excitement of excursions whither they can not tell.[2]

The framers of the Federal Reserve Act, debating and compromising in a political and economic struggle that lasted several years, produced in the Act a flexible charter that provided for an organization capable of change and growth. Although the Act has been amended many times, the System has been able to adapt itself to new conditions without seeking new legislative instructions to care for every new condition. For example, many of the changes made by the Banking Acts of 1933 and 1935 were statutory recognition of changes that had already evolved in the System. Similarly, a decade before the enactment of the Employment Act of 1946, Federal Reserve officials had recognized a responsibility to promote monetary and credit conditions that would encourage high levels of production and employment. In more recent years, acting within the framework of the Federal Reserve Act, the Federal Reserve has developed a variety of arrangements with foreign central banks and has entered into foreign currency transactions in order to protect the dollar in international financial markets.

PRIMARY FEDERAL RESERVE OBJECTIVE

Today the primary objective of the Federal Reserve is to advance the public interest by contributing, to the greatest extent possible, to the fulfilment of our national economic goals. These goals include: (1) maximum sustainable economic growth, (2) reasonable price stability, (3) maximum practicable employment, and (4) equilibrium in international payments.

The Federal Reserve promotes these economic goals by influencing the volume, availability, and cost of the reserves of the member banks. It exerts such influence through three principal instruments of general application: (1) discount operations, (2) open market operations, and (3) changes in reserve requirements. In the early days of the Federal Reserve System, the reserves created by the Reserve Banks arose primarily out of discount operations. Today they arise primarily out of open market operations. Authority to change reserve requirements as an instrument of credit policy had its origin in the Banking Act of 1935.

Policy decisions with respect to these three instruments are not concentrated in any one of the three principal components of the Federal Reserve System. Changes in the discount rate are initiated by the directors of the Federal Reserve Banks, subject to review and determination of the Board of Governors of the Federal Reserve System in Washington. Open market operations are directed by the Federal Open Market Committee. Reserve requirements are fixed by the Board of Governors, or the Federal Reserve Board as it is frequently called.

ROLE OF FEDERAL OPEN MARKET COMMITTEE

In developing credit policy to promote our national economic goals, the Federal Open Market Committee has evolved as the heart of the Federal Reserve System. The Committee is composed of the seven members of the Federal Reserve Board, the President of the Federal Reserve Bank of New York, and four other Reserve Bank Presidents chosen in rotation. The Committee customarily meets every three weeks. In practice, all Federal Reserve Bank Presidents attend all meetings of the Committee. All members of the Committee and all the Reserve Bank Presidents who are not members participate freely in the discussions at the meetings, commenting on business and credit conditions and international financial developments, and expressing their views as to appropriate credit policy and its implementation. Because of the close interrelation of the three principal instruments of credit policy, the use of the various instruments is discussed even though the Committee has jurisdiction only with respect to open market operations.

Each Reserve Bank President brings to the discussion not only the findings of his Bank's research staff which has special concern with economic and financial developments in his District, but also information and judgments on the part of the Bank's directors and other business and banking leaders in the District. Thus, information gleaned throughout the United States and opinions formed on the basis of a variety of contacts with Government leaders and with lenders and users of credit in every section of the country are melded with the analysis of national data in the formation of national credit policy.

Everyone in attendance at a meeting of the Committee does not assess business and credit conditions and international financial developments in the same way. Every-

[2] 50 Cong. Rec., Part I, p. 3 (1913). The first part of the quotation, i.e., through the words "should be", appears on a bronze plaque in the lobby of the Federal Reserve building in Washington.

one does not propose the same prescription for credit policy. Yet the method used and the practices followed do constitute a mechanism calculated to produce a balanced judgment in an area where exactness is impossible and where careful and deliberate judgment on all available facts is essential.

STRUCTURE OF SYSTEM

From time to time it has been suggested that the Federal Reserve be made directly responsible to the Executive Branch of the Government. Some critics who seem to be overly concerned with simplicity in an organization chart have suggested that, while the System is working pretty well, nevertheless its efficiency could be improved by some kind of streamlining.

I suppose someone bent on textbook chart-making might urge a substantial revision of the United States Constitution to simplify what may appear to be a complicated Governmental structure, and to promote greater efficiency in Government. I would venture to suggest, however, that the separation of powers among our three branches of Government, as provided in the Constitution, has been an important factor in the development of our nation and the preservation of the individual freedom of its people. The basic question is, "How well does the present system work?"

While some persons may consider the structure of the Federal Reserve System cumbersome as they read the language of the Federal Reserve Act dealing with the System's component parts, I submit that the evolution of the System has produced a well-balanced and effective mechanism for policy formation.

INDEPENDENCE OF SYSTEM

We frequently hear questions about the independence of the Federal Reserve System. Some say it is too independent; some say it is not sufficiently independent. I think we should always bear in mind that the Federal Reserve System is not, and should not be, independent from the Government. Whenever stress is placed upon the need for independence of the System, it is independence within the Government. In the administration of monetary policy the Federal Reserve System is an agency of the Congress, established to carry out the responsibility for that task which, under the Constitution, belongs to the Congress but which the Congress cannot administer from day to day. In the nature of things, Congress has to delegate some segments of its power to agencies which it has created. The System must, and does, seek to carry out the basic policy of Congress, and Congress can change that policy at any time. When we talk about the independence of the Federal Reserve System, we are talking about the independence to make day-to-day decisions which will best serve to carry out the basic policy established by the Congress.

Two months ago the Secretary of the Treasury, appearing before a Congressional committee, discussed the relationship of the Treasury and the Federal Reserve. He said:

> . . . experience over many years and in many countries has taught the wisdom of shielding those who make decisions on monetary policy from day-to-day pressures. The day of private central banks operating without regard to Government policy is long since gone, and quite properly so. But around the world, almost all countries still find it useful to maintain independence for their central banks within the Government.
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> Independence naturally implies the right to disagree; and not only to disagree, but to act on the basis of different judgments. Some differences between the Treasury and the Federal Reserve may from time to time be a fact of life. But this need not be distressing. The necessity to test policy proposals against the views of an independent Federal Reserve is, I believe, the best insurance we can have that the claims of financial stability will never be neglected.[3]

We in the Federal Reserve share the Secretary's views on the need for an independent "Fed". In my own experience of nearly thirty years in the System, the independence of the "Fed" within the Government, in addition to its other advantages, has been an important factor in achieving an effective organization staffed by competent and imaginative persons.

AREAS FOR LEGISLATIVE CONSIDERATION

There are, however, other areas in which changes in the Federal Reserve Act do appear to merit consideration. I would comment briefly on four such areas. These are reserve requirements, eligibility requirements, the mandatory regulation of interest rates, and Federal bank super-

[3] *The Federal Reserve System After Fifty Years,* Hearings before the Subcommittee on Domestic Finance of the House Committee on Banking and Currency on H.R. 3783, H.R. 9631, H.R. 9685, H.R. 9686, H.R. 9687, and H.R. 9749, 88th Cong., 2d Sess. (1964), Vol. 2, p. 1232.

vision. Finally, I would like to say a few words about the banking structure in New Jersey.

RESERVE REQUIREMENTS. In my view, all commercial banks—both member and nonmember—should be subject to the same basic reserve requirements. The major purpose of legally required reserves today is to serve as a fulcrum for monetary policy. Deposits in nonmember banks are just as much a part of the money supply of the United States as deposits in member banks. Yet, the reserve requirements applicable to member banks and to nonmembers are frequently quite different. Reserve requirements imposed on nonmember banks by the laws of the respective states tend to be less onerous than those applicable to member banks. In some states, the level of requirements is lower for nonmember banks. In some, the form in which reserves may be held is more favorable to nonmember banks. For example, in some states reserves may be held partly in the form of securities and, therefore, may earn interest. These differences in reserve requirements tend to confer a competitive advantage on nonmember banks by permitting them to offer more attractive terms to borrowers and depositors, or to earn higher profits than member banks can earn in similar circumstances.

Since the basic purpose of reserve requirements is to provide a mechanism for the promotion of our national economic goals, all commercial banks should participate on a similar basis. Such participation could be attained by compulsory membership of all commercial banks in the Federal Reserve System or by requiring that all commercial banks be subject to the same reserve requirements. Membership in the Federal Reserve System brings with it, of course, the privilege of access to Federal Reserve discounts and advances—a valuable privilege in time of need.

Membership also brings the duty to remit at par for checks drawn upon the member bank. Par clearance has been the rule in New Jersey for decades. Universal par clearance is highly desirable but, unfortunately, even after fifty years of effort the goal is far from attainment. Compulsory membership would materially affect the 1,600 banks that do not now remit at par. To require at this time full membership for all commercial banks, with immediate universal par clearance as a consequence, would provoke needless controversy.

The capacity of the Federal Reserve to make monetary policy effective, and the promotion of equity among different classes of commercial banks, would be served by requiring that all commercial banks, both member and nonmember, be subject to the same reserve requirements without, however, requiring that all commercial banks be members of the Federal Reserve System. If nonmember banks are subjected to the same reserve requirements as member banks, perhaps the nonmember banks should have the same access to Federal Reserve discounts and advances as do member banks. This is the recommendation made by the Committee on Financial Institutions (the "Heller Committee") in its report of April 10, 1963 to the President of the United States.

At the same time, for the purpose of eliminating many of the inequities and administrative difficulties in the present reserve requirements, the Committee recommended a graduated system of reserve requirements to replace the present system which involves different reserve requirements for reserve city banks and for "country" banks. Under such a graduated system every bank would maintain a low reserve against the first few million dollars of its demand deposits, a higher reserve against its deposits above this minimum amount and up to a substantial figure, and a still higher reserve against any demand deposits above the latter amount. This recommendation certainly merits careful study.

ELIMINATION OF ELIGIBILITY REQUIREMENTS. The time has come, I think, to repeal the present provisions of the Federal Reserve Act regarding the eligibility of paper for discount by the Reserve Banks, and to authorize the Reserve Banks to make advances to member banks on their promissory notes secured to the satisfaction of the Reserve Banks, subject to regulations of the Board.

The original Federal Reserve Act authorized the Reserve Banks to discount only certain types of paper arising out of "actual" commercial or agricultural transactions, subject to specified maturity limitations. The concept underlying this limited authority was that the liquidity of commercial banks could be assured only if the loans made by them were short term and self-liquidating in character. Related to this "real bills" concept was the assumption that the pledging of such discounted paper by the Reserve Banks as security for the issuance of Federal Reserve notes would automatically regulate the volume of money; it was expected that the volume of money would expand and contract directly in response to the varying credit needs of the economy, as reflected by the volume of short-term borrowing by commercial and agricultural enterprises.

For many years it has been generally recognized that the concept of an "elastic currency", based on short-term self-liquidating paper, is no longer in consonance with banking practices and the needs of the economy. The narrow, technical requirements of the law regarding "eligible paper" serve no useful purpose. It is preferable to place emphasis on the soundness of the paper offered as security for advances and the appropriateness of the purposes for which member banks borrow. Bills[4] recommended by the Federal Reserve and now before the Congress would make such a change.

REGULATION OF INTEREST RATES. The Federal Reserve Board is required by the Banking Act of 1933 to specify the maximum rate of interest that may be paid by member banks on savings and time deposits. The Federal Deposit Insurance Corporation has a similar responsibility with respect to insured nonmember banks. Presumably the purpose of the requirement was to help assure sound banking—to deter banks from seeking assets with higher yields but of lower quality in order to pay high interest rates on deposits.

As a nation we are generally committed to the proposition that competition should be fostered and that the public interest is better served when the forces of supply and demand are permitted to reflect themselves in prices. We look to market forces to promote a satisfactory allocation of resources. Must we have a continuing regulation of interest rates to insulate them from market forces?

There have been substantial improvements in bank examination and supervision in the three decades since the Banking Act of 1933. Federal deposit insurance has virtually removed the possibility of panic runs on banks. Stock market credit has been regulated. I think that the mandatory regulation of interest rates is not generally needed in order to prevent banks from acquiring unsound assets and that, as money rates and yields on securities fluctuate in response to changing market conditions, commercial banks should normally be free to adjust to those conditions the interest rates they pay.

In addition, the present statutes regulating interest rates apply only to commercial banks and not to other competing institutions. Therefore, those institutions have a competitive advantage over commercial banks.

Under the circumstances it would seem desirable that the regulation of interest rates paid by commercial banks on time and savings deposits be made permissive rather than mandatory. By making the authority permissive, it would still be possible for the supervisory authorities to intervene, if necessary, to help prevent the payment of excessive interest rates and unsound practices in extending credit. Such a stand-by authority should be extended, I believe, to include, under a coordinated approach by the appropriate regulatory authorities, savings and time deposits and similar accounts of savings banks, savings and loan associations, and perhaps credit unions.

FEDERAL BANK SUPERVISION. The Federal Reserve and the state supervisory authorities share the responsibility for examining and supervising state member banks. The performance of this responsibility has brought to us in the Federal Reserve an intimate knowledge of the day-to-day problems of the banks, and thereby has contributed importantly to the capacity of the Federal Reserve to carry out its basic responsibilities in the field of monetary policy. In addition, it has enabled us to observe at first hand the effects of monetary policy not only on individual banks but also on their borrowing customers.

The Federal Reserve is one of three Federal bank supervisory authorities. Effective Federal bank supervision requires a consistent approach to common supervisory problems. A basic problem has been the divergent interpretation and, therefore, varied administration of similar or even identical statutes. The result has been confusion and inequity. A consistent approach requires close cooperation among the Federal agencies. In the absence of such cooperation, some consolidation of those agencies or other arrangements may be called for. Over the years there have been many suggestions to this end.

At the very least, a greater degree of coordination is needed. Clearly, there should be an effective mechanism for the reconciliation of divergent views. I would hope that this could be accomplished without removing the Federal Reserve from a supervisory role because I feel that role contributes importantly to the formulation and execution of monetary policy.

BANK MERGERS, ETC. Most of the time-consuming burden of bank supervision at the policy level these days lies in the consideration of what might be called structural changes of the banking system, i.e., bank mergers, holding company acquisitions, new branches, and new bank charters. Federal jurisdiction over holding company applications is centralized by law in the Federal Reserve Board. In contrast, jurisdiction over bank merger applications is divided by law among the three Federal bank supervisory authorities. Although in both cases the Federal statutes provide for the submission of advisory opinions by other supervisory authorities to the deciding agency, there have been differences in approach and emphasis in the decisions rendered. In addition, the Department of Justice has certain responsibilities with respect to both holding company acquisitions and bank mergers. Better coordination is clearly needed.

With appropriate legislative changes, many of the decisions which are now made in Washington might be effectively delegated to regional groups composed of repre-

[4] S. 2076, 88th Cong., 2d Sess. (1964); and H.R. 8505, 88th Cong., 2d Sess. (1964).

sentatives of state banking authorities as well as of the Federal banking authorities, including the Federal Reserve Banks. Such delegation seems especially appropriate in the case of branch applications. Action at the regional level might, in many cases, become final without intervention by Washington.

If the only solution to the coordination problem is consolidation, it can be persuasively argued, I believe, that bank supervision is a logical adjunct to the formulation and execution of monetary policy and should be consolidated in the Federal Reserve System, with adequate authority on the part of the Federal Reserve Board to delegate much of the work to the Federal Reserve Banks.

BANKING STRUCTURE IN NEW JERSEY

In enumerating four areas for change in the Federal statutes, I would not imply that they are the only areas needing adaptation to current conditions. They are, however, important areas which seem to me to merit your special consideration. Nor would I want to convey the impression that it is only Federal banking law that needs review.

When I addressed your convention two years ago I asked a question: "Would it not be in the best interest of banking for you, the bankers of New Jersey, to recommend some minimum improvements in the Banking Law at this time in order to move forward toward the dual goals of greater efficiency and effective competition. . .?"

Since that time you have given a great deal of thought and study to the banking structure in the state. In the Federal Reserve we have followed these discussions with great interest. We have, I think, a justifiable concern with the ability of the banking system to supply the growing credit needs of the economy. These needs become not only larger but more complex as rural areas are developed into the vast industrial and residential complexes that are visibly spreading out from the major metropolitan areas of New York and Philadelphia. With these economic changes the pressures for banking change are intensified.

Those who advocate larger banking organizations in New Jersey have pointed out that the largest banks in the state are dwarfed by New York City and Philadelphia banks. It has been said that these giant competitors "siphon off" deposits and loans that should rightly go to New Jersey banks. Would it not be more reasonable to say that large institutions in neighboring states are supplying many of the credit needs that, because of legal restrictions or for other reasons, New Jersey institutions are unable to provide? The essential point is that the users of bank credit are probably getting the credit they need. Where the supply comes from is a matter of convenience, perhaps, but, more importantly, a matter of that entire complex of services, including the ability and the eagerness to provide them, that goes into a well-rounded banking relationship.

Not only are we in the Federal Reserve charged with the duty of preserving effective competition in banking, but we believe in it. We believe that it serves the public interest. We envisage changes in the banking structure of New Jersey as a means of increasing competition. Larger New Jersey banking organizations would be better able to compete for the "big business" of the state. It is futile to dream that they would get it all, but we would hope that their competitive vigor would, in large part, compensate for discrepancies in size alone which can probably never be eliminated.

Banking competition today is as much a matter of specialized services, techniques, ingenuity, and enthusiasm as it is of lending limits. As larger banks are able to assist more effectively in the development of industry in New Jersey, retail as well as wholesale banking business will also expand; all New Jersey banks, both small and large, are bound to benefit.

Even those who may agree with these broad objectives may not agree on the best way to accomplish them. It appears, however, that out of the discussion that has been going on in New Jersey there is growing support for legislation that would permit the operation of bank holding companies on a state-wide basis.

I would like to make two observations on the challenge to banking in New Jersey presented by the prospect of such legislation. The first concerns the holding company as a form of operation. Some people equate a holding company organization to branch banking, but they are not, in fact, equivalent. Some argue that branch banking is more efficient. On the other hand, a holding company offers the possibility of preserving the home-town characteristics of a local bank (which are cherished by so many bank customers) while at the same time providing the means for larger and more specialized financing efforts. Truly interested local directors who determine the policies of a local unit of a holding company organization can make a major contribution to the effective service the bank can render to its community. Large size is unquestionably a requisite for adequately providing large loans and the more complex banking services. Large size, however, is not essential to serve the varied needs of individuals, homeowners, and small businessmen in that profitable area that has come to be called consumer banking. In that area even the smallest bank can remain an effective competitor. The holding company organization constitutes a challenge to the management of the local bank to serve its community better, while at the same time providing the additional benefits associated with size that the holding company is able to offer.

My second observation is a word of caution. The formation of a holding company and the acquisition of a bank by a holding company require the approval of the Federal Reserve Board. In reviewing a holding company application, the Board must consider whether the proposal would expand the size or extent of the bank holding company system involved beyond limits consistent with adequate and sound banking, the public interest, and the preservation of competition in the field of banking. Also pertinent in this field are the criteria used by the courts in deciding cases that arise under the Clayton Act dealing with acquisitions which may substantially lessen competition or tend to create a monopoly, or that arise under the Sherman Act dealing with acquisitions which may unreasonably restrain trade. The Supreme Court of the United States has equated excessive concentrations of banking resources in the relevant markets to undue lessening of competition, as well as to unreasonable restraint of trade. The Board will approve only those applications which, in the light of the competitive factors and the applicable banking factors, it finds to be in the public interest.

We would expect, therefore, that those banks which choose to band together to improve their potential of service to the public will seek to do so in ways that will enhance competition rather than reduce it.

CONCLUSION

In conclusion, I would revert to President Wilson's inaugural address. "We shall deal with our economic system as it is and as it may be modified, . . . and step by step we shall make it what it should be. . . ." These words, spoken fifty-one years ago, were truly prophetic of the years since then, and I trust of the years ahead. When these words were uttered, no one would have dreamed of the challenges our nation and our banking system would have to face. No doubt the challenges that lie ahead are beyond our imagination today. But whatever our respective challenges, we must be ready to meet them—and meet them well. Our success and your success in meeting them will be related to the extent that each of us realizes that the success of any governmental body and of any private organization rests on its service to society.