Fiftieth Anniversary of the Federal Reserve System—Early History of Earnings and Expenses*

Relying in part on the experience of other central banks, the legislators and banking experts who drafted the Federal Reserve Act expected that the earnings of the new Reserve Banks would tend to average higher than their expenses. The distribution of these earnings was therefore carefully specified in the act.

First there was provision for a 6 per cent cumulative dividend on capital stock purchased by member banks. Earnings in excess of these dividend payments were then to be paid to the United States Treasury (except that one half of the excess was to be retained until the surplus account equaled 40 per cent of paid-in capital). Until 1933 these payments to the Treasury represented a "franchise tax". In that year the tax was repealed to permit the Federal Reserve Banks to replenish their surplus, which was substantially reduced when an act of Congress required the Banks to subscribe $139 million to the capital of the new Federal Deposit Insurance Corporation. Since 1947, payments to the Treasury have been made as "interest on Federal Reserve notes".

Although the sources of potential Reserve Bank earnings—loans and rediscounts for member banks and interest on securities acquired in open market operations—were well known from the outset, a few member banks were pessimistic about the prospect of receiving the return specified by the statute. In New York State, the directors of one member bank stated publicly that they were writing down to zero the value of their Reserve Bank stock since they did not foresee any dividend payments.

In late 1914 and through 1915, such pessimism proved temporarily justified as total earnings of the Federal Reserve Banks were in fact small. The Federal Reserve Act had lowered reserve requirements of national banks, and this step, coupled with an inflow of gold, brought about conditions of monetary ease so that there was little need for rediscounting. Through the end of 1915, the twelve Reserve Banks accommodated 2,073 member banks, but these discounts had totaled only $183 million.

With respect to the acquisition of earning assets through open market operations, the New York Federal Reserve Bank noted that suitable investments were in strong demand, causing interest rates to decline. In its first *Annual Report,* the Bank stated:

> Realizing the influence which the reserve bank might have upon these rates if it pressed its funds upon the market, it has been the policy of the bank to follow rather than lead the market in its decline. In these circumstances, no thought could be given to earning dividends.

Thus, from the beginning, the System felt that central bank decisions should not be influenced by considerations of earnings.

In the aggregate, current expenses of all the Reserve Banks exceeded earnings by $141,000 between the beginning of operations in November 1914 and the end of 1915. Reflecting regional conditions, results varied among the Banks and two Banks actually posted sufficient earnings after expenses to initiate dividend payments. However, it was estimated that additional net earnings of approximately $3.4 million would have been needed to meet dividend requirements of all twelve Banks.

In 1916, earnings of the Banks rose while expenses, no longer affected by organizational outlays, remained steady. The twelve Banks were therefore able to declare partial dividends of $1.7 million on member bank stock. In 1917 war financing swelled earnings, and at the year end the Reserve Banks made their first transfers to surplus and payments to the Treasury. By June 1918 all the Reserve Banks had brought dividend payments up to date.

Since that time, there have been four years in which Reserve Bank earnings have not covered expenses and dividends. Over the past fifty years as a whole, however, the System has paid into the Treasury more than $7.8 billion—an amount that far exceeds the $559 million in dividends paid to member banks on capital stock during the same period. Last year the Reserve Banks' current earnings were $1.15 billion, their current expenses $187 million, dividends $29 million, transfers to surplus almost $56 million, and payments to the Treasury $880 million.

* The seventh in a series of historical vignettes appearing during the System's anniversary year.