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The Reserve Banking System of the United States

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PRESIDENT G. M. SMITH:—The subject of the address today is "The Reserve Banking System of the United States," and the speaker is Mr. George DeCamp, of Cleveland. To Mr. DeCamp we extend a very cordial welcome to the Canadian Club of Toronto. The subject is one of very great interest and we are very fortunate, I think, to have a speaker who is active head of one of the Federal Reserve Bank Districts. The Federal Reserve System seems to me, I speak from much ignorance, to be one of the great constructive measures of modern legislation. The men who made that System attempted what was almost a miracle and after sixteen years experience one can see that the miracle has been achieved. The Reserve System, so far as I can see, did a great deal to help the financing of the war and to carry forward the expansion of American industry since the war. It has helped to make New York a great financial market; it has alleviated at least several crises in the course of the last decade and, I think, has probably prevented a much more serious crisis like that of 1907. I have the greatest pleasure in introducing Mr. DeCamp to speak of the Federal Reserve System.

MR. DECAMP:—Mr. President, members of the Canadian Club of Toronto, I wish to express my very great appreciation for the privilege of being your guest today. It is a delight to me at any time to be in your splendid city. It is a delight for a great many of my fellow citizens to

come this way, and, it is a joy to us when you find it in your way to come south.

To discuss adequately the reserve banking system of the United States and to delineate the advantages which the establishment of our regional bank plan has brought to American business, it is desirable to review, very briefly, conditions prior to the passage of the law giving birth to these new institutions. The best measure of results achieved is obtained through a comparison of conditions then and the situation as it exists today, insofar as reserve bank activity has been responsible for bringing about changes in our business and credit structure. In reviewing this latter item, it is my purpose to confine my remarks largely to the set-up and mechanics of the system, since time will not permit discussion of the broader subject of policies.

During the past half century our industrial development has proceeded at an astonishing rate. Fifty years ago two-thirds of our population lived in what our census classification describes as rural territory. At the present time, two-thirds of our people live in urban sections. The population of New York City alone is now greater than that of our ten largest cities, including New York, in 1880. Chicago, today despite decimation of its citizenry through gang warfare, is larger than New York, Philadelphia and Brooklyn combined fifty years ago. A substantial part of the increase is traceable to the absorption during this period of a tremendous flood of immigration; but no small part represents a shifting of labor to the more important manufacturing centers to meet demands of expanding industry for man-power.

It is obvious that business expansion is limited to the capacity of its own capital and the existing credit agencies to finance its operations. It is equally true that banking in the United States had failed to keep step with industrial and commercial progress. The result was periods of credit stringency which occurred with annoying frequency, often aggravated by actual shortages of currency. Our credit system was inflexible and our currency system hopelessly inelastic. Industry can bear the burden of moderately high money rates, but it is difficult for it to function when it is unable to secure adequate supplies of credit at any price.

The weaknesses of our currency systems had long been recognized. Important trade and banking bodies had frequently importuned Congress for relief and, following the panic of 1907, the National Monetary Commission was created "to enquire into and report what changes are necessary in the monetary system of the United States."

As a result of the exhaustive studies made by this Commission, which covered the banking and currency systems of nearly all the important nations of the world, there were developed the much-needed reforms through the creation of a regional system designed to provide enlarged banking facilities, the flexibility and adequacy of which have been so well demonstrated during the past fifteen years.

While so far as my knowledge goes the regional system is unique, it is, after all, merely a variation of the "mother" type of central bank, the "Old Lady of Threadneedle Street." We in the United States often wonder if any of our great American banks will ever attain to the mellowness of age when they will be looked upon with the affectionate respect and be endowed with actual personality such as that of which the "Old Lady" is now possessed. The increasingly friendly understanding between American and British bankers in the furthering of world monetary stability has created a genuine interest in the Bank of England, particularly since our own new bank plan has been patterned so closely after the British system. Nor do the vicissitudes of its early history fail to provide a warning (and sometimes a comforting parallel) to our own harassed officials in working out precedents and policies upon which our operations are to be based in the future. We lack the experience of the great European central bank, and policies have had to be formulated to meet changes in conditions as they arose. Despite errors of omission and commission, however, there is in the United States, as through the rest of the world, a growing conviction that the fundamentals of the American system are sound; that it has functioned under conditions trying enough to demonstrate its inherent worth.

Since early colonial days, banking in the United States has been the subject of never-ceasing discussion. In 1791 the first bank of the United States was organized, but state

bank opposition defeated a renewal of its charter twenty years later. In 1817, the second bank of the United States was chartered for a twenty year period, but political opposition again defeated renewal of the charter. A new charter was secured from the State of Pennsylvania, but after a precarious existence of a very few years the second bank finally closed its doors in the year 1841.

During this period, a large number of banks was organized under charters granted by the various states, under laws which were far from uniform. In some of the states a determined effort was made to provide sound banking, but laxity in the law and lack of inspection were handicaps too great to be overcome. In most states almost anyone could obtain the power to organize a bank and issue circulating notes. It is not difficult to imagine the confusion resulting from such a situation, and the difficulty of circulating notes in sections where the stability and soundness of the issuing institutions were not well known. A traveller setting forth from New York to the West would find his notes depreciating as he travelled, exchanging them for other notes as he reached the territory served by other and locally better-known banks of issue.

Under these chaotic conditions business struggled until during the third year of the war between the states, when the National Banking System was brought into being. The law creating these institutions was born of war necessity. The credit of the United States was impaired; Government bond issues were floated at interest rates as high as 7.3%; the gold standard had been abandoned and current expenses of the Government were met through the issue of Treasury Notes, commonly called greenbacks, which were fiat money in every sense of the word, although made legal tender for all public and private debts except customs duties. Bonds of the Government, despite the attractive rates, were at heavy discounts, and the greenback depreciated until it was worth but forty cents in gold.

Banks organized under the National Banking Act were required to subscribe to bonds of the Government, against which, when deposited with the Treasurer of the United States, circulating notes could be issued. This provided the Government with a market for its war issues, and, at the

same time, furnished a substantial increase in the supply of currency. It was the intention that the national banks should form the backbone of the nation's commercial banking system, and for a period of many years the burden of financing growing industry in the United States was assumed largely by the banks organized and operating under national charters. In 1866, the year following the successful outcome of the Civil War, a tax of 10% upon state bank note issues forced them out of existence.

For a period of fifty years following the establishment of the national system, notwithstanding the tremendous strides made by American business, there had been no substantial or material change in the banking law. There were numerous fundamental weaknesses, but the three major indictments against the then-prevailing system were:

1. An immobility and a wide scattering of banking reserves.
2. A lack of banking machinery designed to permit expansion of credit in periods of unusual business activity or, at times, of seasonal strain, and
3. A lack of elasticity in the national currency.

Each of these items constituted a menace to national financial security. We were then operating under a plan that called for certain definite fixed reserves which, under the system of re-deposit then in vogue, tended to concentrate in the larger financial centers where they were loaned, generally in the call-money market on stock exchange collateral. In a sense, reserve funds actually were no longer cash reserves, since they had been invested by the depository bank. In emergencies, these deposited reserves were available only to the extent that the loans made on the basis of these deposits could be called—in other words, to the extent to which securities pledged against them could be sold. Since heavy selling of securities in such situations would bring pressure upon the security market, sometimes accompanied by severe declines in quotations, the result was only too often to create apprehension of fear to the point where panic conditions developed. There are many in this audience who remember conditions in 1907, when it became almost impossible for the banks to obtain balances due them from other banks. That situation was typical of too-

frequent such episodes in American financial history, developing sometimes overnight and without warning.

Nor could reserves be mobilized promptly in times of emergency. The situation has been likened to that of an efficiently-trained army organization of effective size if concentrated at one point, divided into small squads and maintained at a number of scattered points throughout the United States. When danger threatened, each community would wish to maintain its own garrison for its own defense. Its fighting strength could not be consolidated for concerted action. Under our unit banking system each bank was concerned primarily for its own safety, and co-operative action for the general good was difficult to obtain.

The fixed reserve limits imposed by law on commercial banks—much higher than the reserve percentages now permitted—interfered seriously with their lending power. The inability of banks to replenish reserves prevented the making of desirable loans to deserving commercial customers in the highest credit standing, except through the alternative of violating the reserve provisions of the law or obtaining what assistance could be secured through a correspondent bank. Rediscounting on the part of a bank at that time was considered evidence of weakness, which, coupled with the American banking tradition against borrowing by banks, often seriously crippled business activities in our country when financial institutions had reached the limits of their own lending power, notwithstanding the quality of the paper offered, or the necessity of the borrower seeking the loan.

Prior to the establishment of the reserve system there were five forms of money in general circulation in the United States. These were: 1. gold certificates; 2. silver certificates; 3. United States Notes; 4. Treasury Notes of 1890, and 5. national bank notes.

Each had its limitations, and none was susceptible of expansion in any considerable degree. Gold and silver certificates are merely warehouse receipts for metal, since they are secured by gold and silver, respectively, deposited with the Treasurer of the United States, and the amounts outstanding are necessarily limited to the amounts of the metal obtainable. The maximum amount of United States notes (greenbacks) permitted to be outstanding was fixed

by law when specie payments were resumed following the Civil War, at about three hundred and forty-six million dollars—the amount then in circulation—and has since remained unchanged. Treasury notes of 1890 were a relatively negligible quantity and since 1900 have been retired when presented for redemption.

This leaves national bank notes as the only other form of currency, and while they were elastic to a greater extent than the others, they did not have the quality of expansion in sufficient degree. Not all forms of government bonds bore the circulation privilege, and the spread between the amount of such bonds and the volume of notes issued against them was never very great; not enough, in fact, to care for the demands which occurred when business was unusually active, or at crop-moving or holiday seasons, for additional currency. The issue of national bank notes was further restricted because at times when there was the greatest need for additional currency it was more expensive for banks to issue it. In addition, this form of money is open to objections which apply to any bond-secured currency.

As late as 1908, provision was made for an "emergency" currency known as "Aldrich-Vreeland" money, which bore some resemblance to our present Federal Reserve Note in that commercial paper was legally recognized as a proper security for note issues. However, the tax levied upon such circulating notes was so heavy as to force their early retirement. They served only as emergency currency and, in fact, none was issued until August, 1914, when the outbreak of the Great War caused gold withdrawals from the United States in such volume that nearly \$400,000,000 were circulated to avert what might otherwise have been a disastrous panic.

Under the handicap of this antiquated and cumbersome system business struggled until the panic of 1907 crystallized sentiment in the United States that revision of the banking laws could be no longer postponed. The National Monetary Commission was appointed and based upon its recommendations, which, however, were materially altered, the Reserve Bank System was born. The law was passed in December 1913 and in November of the following year, these new institutions opened their doors for business.

The organization committee, to which was delegated the duty of determining the locations for the various reserve banks which the Act specified should be not less than eight nor more than twelve in number, divided the country into twelve natural trade areas known as Federal Reserve Districts, each to be served by a Reserve Bank located in a city which was advantageously situated to serve the banks in the territory assigned to it. Provision was made for a minimum capitalization of four million dollars for each bank, no public offering being made as in each case the required capital was subscribed by member banks. National Banks were compelled to become members of the system while state banks may be admitted to membership upon meeting certain requirements. Originally chartered for terms of twenty years, as in the cases of the first and second banks, the Congress has, by recent legislative enactment, extended their charters for indeterminate periods, giving them succession until charters are revoked by Congress or the banks are closed for violation of law.

While each bank is an autonomous unit all are operated under the general supervision of the Federal Reserve Board consisting of eight members, six of whom are appointed by the President, the Secretary of the Treasury and the Comptroller of the Currency, acting *ex-officio*. The Board interprets the provision of the law and issues regulations governing the general conduct of the reserve banks in their relations with member banks and with each other. Through the Reserve Board the activities of the twelve reserve banks are co-ordinated and national policies are formulated and expressed.

The reserve banks themselves are operated under the direct supervision of Boards of Directors consisting of nine members each. These are divided into three classes and three are elected or appointed annually for three year terms. In the election of directors each member bank, regardless of size, casts but one vote. For election purposes the banks of the districts are divided into three groups consisting of the largest, medium size and smaller banks respectively.

Class A directors are elected to represent the banking interests although the law does not specify that they necessarily be bankers. Class B directors, at the time of their

election, must be actively engaged in commerce, agriculture or some other industrial pursuit and cannot be officers, directors or employees of any bank. Class C directors are appointed by the Reserve Board and cannot be officers, directors, employees or stockholders of any bank. In this manner, is provided on the board of each bank representation on the part of the lending interests, the borrowing interests and the public.

The reserve banks are endowed with usual corporate powers; they are not government institutions since the entire capital is subscribed by member banks and their officers and employees are not government officials and clerks. They act as fiscal agents for the government, but are in part reimbursed for the cost of performing these functions.

With this summary of the set-up of the system, let us proceed to consideration of its mechanics. The preamble to the Act, specifies the purpose of the law in the following language:

An Act 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.

Under these broad powers the reserve banks are functioning. The major defects of the old banking plan have disappeared. Business may expand with reasonable assurance that every legitimate demand for credit can be met and fears of currency panics have been forever dispelled. The expansion of industry and the growth of banking in the United States since the inauguration of the system are unparalleled in world history, and the fact that central banks, patterned after the American Reserve plan have, in recent years, been established in some foreign countries, demonstrates that appreciation of its merits has extended beyond our own borders.

The chief functions of the Reserve Banks are:

1. Custody of member reserves.
2. provision of adequate rediscount facilities.
3. supplying a sound currency which has the capacity to expand or to contract to meet the varying requirements of business, and
4. acting as fiscal agents for the national government.

Acting on the principle that massed reserves are effective reserves, the law compels member banks to maintain their entire legal reserve with the regional banks. Further recognition of the effectiveness of mobilized reserves is found in the material reduction of cash required to be carried against deposit liabilities as compared with previous requirements. Under the national banking system reserves against ordinary deposits varied from 15% to 25% with even higher percentages against bank reserve deposits in some cases. The highest reserve required under the new plan is 13% against demand deposits in the central reserve cities of New York and Chicago, the average for all forms of deposits in the entire United States being somewhere in the neighborhood of 7%. This feature alone has released hundreds of millions of dollars formerly tied up in reserves for the use of business men. Naturally, the total cash reserves of members of the system, representing about one-third of all banking institutions and about two thirds of our entire banking resources, constitute a tremendously large sum of money and furnish the bulk of the lending power of the banks. These reserves are available to business through member banks, when ordinary banking facilities prove inadequate. Reserve banks may discount paper acquired by members which, under the law, is eligible for periods of not to exceed 90 days except for forms of agricultural paper where permissible maturities have been extended for as long as nine months. The law provides that to be eligible for rediscount, the proceeds of paper offered, must have been used or, after are to be used, in one or more of the steps in producing, purchasing, carrying or marketing goods or (solely as a war measure) for the purpose of dealing in U.S. government securities. It will be observed that paper representing borrowing for capital purposes, speculative or otherwise, is not eligible. It is clearly the intention of the framers of the Act that reserve bank funds shall be used only in aiding a movement of goods from point of production to the hands of the final consumer.

Credit operations of the reserve banks are not limited to discounting commercial paper. The note of a member bank collateralized by government securities or by paper which is eligible may likewise be discounted. As a matter

of fact, the bulk of member bank borrowing is done in this form because it is more convenient from the standpoint of the borrowing bank. While it is not the intent of the law that reserve banks shall actively compete with their members, they are free to conduct certain operations in the open market which, in actual practice, are limited largely to the purchase and sale of bankers' bills and government securities. They are authorized to purchase and sell at home or abroad acceptances and bills of exchange which are eligible for rediscount. There are other incidental powers too numerous to mention and of no great importance as a matter of practical operation.

In the event that a reserve bank's own capacity to lend is threatened by reason of the exhaustion of its reserves to the minimum required by law (35% against deposits and 40% against notes), one Federal Bank may rediscount for another. In a country so vast, where in some sections demands for credit at certain seasons of the year are great while in others it is slack, it is possible thus to employ excess funds in one district to relieve temporary pressure in another. This is effective use of bank reserves, tending to stabilize interest rates and permitting business in a given section to expand beyond the capacity of its own credit agencies to finance its operations.

With the advent of the Reserve Banking System there came into being the federal reserve note—a form of currency that is elastic in high degree—resting upon the substantial foundation of the gold reserve of not less than 40%, the balance consisting of paper eligible for rediscount at or purchase by a Federal Reserve Bank, *i.e.*, paper evidencing indebtedness incurred to carry on current self-liquidating transactions. In a sense it is unique in that, itself a "promise to pay," it is based in part upon the promises-to-pay of our business men.

That this new money has fulfilled its mission is demonstrated by the fact that during the period of greatest strain to which our financial machinery had ever been subjected there was at no time a question as to the adequacy or soundness of our currency supply.

The essential requirements of a sound currency may be quite briefly stated. The security behind it must be ample

to assure its ultimate redemption; it must be convertible at par into other kinds of currency in general circulation; there must be public confidence in its integrity; and last, but by no means least, it must be adequate at all times to meet the demands of business. A currency which is basically sound so far as the first three above-mentioned items are concerned clearly fails of its purpose if it be insufficient in volume. Even gold itself (barring obvious drawbacks to the use of the metal as money) while sound would not be satisfactory if the amount available for circulation were insufficient to meet public requirements.

There are but two limitations upon the issue of federal reserve notes. One is that a gold reserve of at least 40% against outstanding circulation must be maintained. The other is the amount of discounted or purchased paper available to complete the hundred per cent coverage. Our gold supply has been ample, and in periods of business activity, when bank credit is in great demand for productive or distributive uses, eligible paper is created in large volume and eventually may find its way into the reserve banks, where it forms the basis of currency issues to satisfy the demands for increased supplies of money to meet larger payrolls, or pay for commodities at the higher price levels usually accompanying increased activity.

The capacity to expand the volume of currency to meet trade needs carries with it, however, the responsibility for providing for contraction as these needs disappear. Since paper discounted at a reserve bank is of short maturity—the average for the industrial district is but a few days—the collateral behind the notes outstanding is constantly disappearing. If business continues active, new obligations are substituted for those which have been liquidated. If business recedes, then the occasion for the larger issues has disappeared; currency soon becomes redundant at the bank and it is shipped to the reserve bank to liquidate member bank indebtedness there or for retirement. In a broad sense, then, it might fairly be said that the federal reserve note is almost automatic in its capacity to expand and to contract.

In their capacity as fiscal agents for the Government the reserve banks handle subscriptions to Treasury issues,

make conversions and exchanges of outstanding bonds, pay coupons and render other incidental services. Since the abolishment of the sub-treasuries they also serve as currency depots, issuing, exchanging and redeeming all forms of U.S. money.

There are other features of reserve banking not mandatory under the law, but instituted in the interests of business. Among these may be mentioned: 1. Inauguration of the gold settlement fund. 2. Establishment of more efficient machinery for the collections of cheques, drafts, etc. 3. Provision for almost instantaneous transfer of balances by wire. 4. The collection and publication of important financial, trade and production data, in order that business and public may be better informed as to business conditions and trends.

One might also mention the plan, just announced this month, for conversion of Canadian currency spent in the United States into American funds at cost to the reserve banks of shipping and exchange charges. This should do much toward increasing the acceptability of Canadian money by American merchants, particularly along the border.

The gold settlement fund operates as a national clearing-house for settlements between federal reserve banks. It consists of a fund that at this moment amounts to about six hundred millions in gold, held at the Treasury Department at Washington under control of the Federal Reserve Board, in which all of the reserve banks have balances. Through a system of leased wires, charges and credits to the accounts of the other reserve banks, are telegraphed daily by each bank, and through book entries shifts in the gold pool are made. Not a cent has been shipped or handled yet the ownership of the gold has changed just as effectively as though a physical transfer had taken place. The settlements through the Fund reached staggering proportions, in 1928 the total volume being more than one hundred and thirty billion dollars. Yet this was accomplished with a net change in gold ownership that was negligible.

One of the first steps of the reserve banks was to develop a plan for the more prompt collection of cheques. The methods employed previously were slow or costly, since to

avoid payment of exchange charges cheques were forwarded for collection over circuitous routes, often being days on the road from the bank where deposited to the bank upon which drawn, notwithstanding that the distance between them may have been short. Furthermore, under the old system cheques deposited with a reserve agent for collection were counted as reserve on the part of the depositing bank.

From a voluntarily plan of clearance through the reserve banks, the results of which were never satisfactory, the plan developed step by step until cheques drawn on all member banks, are collected by federal reserve banks at par. The voluntary co-operation of non-members was sought and in some districts cheques are collected at par on *all* banks.

The saving to business through reducing the time cheques are in float is apparent, since normally the proceeds of cheques deposited are not available until converted into collected funds. Under the federal plan, cheques received are forwarded to the reserve bank of the district in which they are payable. When the proceeds are in the hands of the collecting reserve bank, credit is passed through the gold settlement fund to the depositing reserve bank. In other words, the proceeds of a cheque drawn on a San Francisco bank deposited in a Cleveland bank are available in Cleveland the day the cheque is paid in Frisco. Credit actually is passed according to a time schedule, worked out on the basis of the average time required to collect cheques in certain sections.

The transfer of balances over the wire is a matter of minutes through the gold settlement fund. A bank in Cleveland, for example, wishes to transfer \$100,000 from its New York to its Chicago correspondent. Upon receipt at New York of the Cleveland bank's request, the depository bank would advise the New York Federal Bank to charge its reserve account \$100,000 and transfer that sum to Chicago Federal for credit to the account of the Cleveland correspondent. The New York Federal would wire the Board to make the transfer, advising the Chicago Federal of its action. The Board makes the required entries in the books of the fund, reducing New York's share in the gold pool by \$100,000 and increasing Chicago's by a similar amount. The entire transaction may

be concluded in fifteen minutes, an actual transfer of a large sum of money from New York to Chicago has been effected, yet not a penny of money has been touched.

For years the Reserve Board and the reserve banks have collected important business data, and have analyzed, interpreted and published the results. In no country of the world is there available to the business man information as to the state of business and finance more complete than in the United States. He knows, or should know, his status in the economic picture. He is able to guide his activities on the basis of known facts, rather than to depend upon hunches. This is an incidental service, but one of inestimable value.

This outline, I hope, will leave with you a fairly comprehensive idea of our reserve banking system. Many of the ills inherent in the old plan have disappeared. We do not maintain that the new system is a perfect piece of machinery, nor that it will prevent excesses on the part of business. It is not an insurance policy against human errors or bad judgment. Based on fundamentally sound principles, however, it has functioned smoothly under widely-varying conditions, and has, as it deserves to have, the respect and support of American business. Perhaps that, after all, is its crowning achievement.