CENTRAL BANKING IN THE UNITED STATES

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THE United States had a central bank during the early years of its development (1791-1811) called the First Bank of the United States and again a less efficient copy of the First Bank of the United States from 1816 to 1836 called the Second Bank of the United States. In addition to handling the business of the government, these central banks also completed with the privately owned commercial banks of the country in meeting the banking needs of the business community. It was this competitive activity in the private economy, plus the activity of these two central banks in controlling the bank note creation activities of the privately owned banks, which created the political opposition that resulted in popular opposition to this type of central bank organization. The result was the refusal of Congress to renew the charter of the Second Bank of the United States, and the United States did not have another central bank until 1913. During this interval of about 75 years the United States utilized the Independent treasury procedure of handling government funds with an assist from the system of National Banks after 1867.

The Independent treasury procedure provided for the payment of taxes and other amounts due the government in specie to an office of the treasury. Also all disbursements of the government were made in specie from an office of the treasury. This procedure eliminated the need for the use of banking facilities in the conduct of government fiscal activities. It also, of course, meant a considerable drain of the specie reserve of the nation when large tax payments were made or if the treasury accumulated a surplus. This was not the hardship it appears to be because at that time customs receipts, ordinarily paid in specie, were 90 per cent of the treasury receipts. Another and more serious difficulty of the Independent treasury arrangement was that it made the government completely dependent upon

private financial and banking agencies if it required funds in addition to tax receipts. This difficulty was mitigated somewhat by the introduction of the National banking system which provided for the issuance of national bank notes guaranteed by the government and backed with government securities.

The Independent treasury system and the national banking system existed side by side until the establishment of the Federal Reserve System in 1913. The Federal Reserve assumed all the functions of the Independent treasury and gradually the bank note provision function of the commercial banks.

The Federal Reserve System was established by Congress in 1913 after over four years of active discussion and debate. The demand for a central bank arose most directly out of a belief that a central bank would avoid the severe money panics which had arisen in 1907 and rather frequently during the previous twenty years. Secondly it was believed that a central bank could make the United States a more desirable center for the conduct of international financial transactions and in this way partially eliminate the monopoly of Western Europe and particularly London over this activity. Finally the personal check had become by far the most common means of payment and a central bank was needed to increase the efficiency of check clearance procedures. The use of central banking tools to eliminate inflation or deflation did not enter actively into the considerations resulting in the Federal Reserve System.

It seems rather unbelievable today that a central bank would be established without seriously considering its effect on the development of inflationary or deflationary conditions. However, this was possible in 1913 because it was generally believed that price levels were caused by the value of gold which was in turn determined by the cost of mining a specified quantity of gold. Obviously a central bank's influence on the availability of gold deposits would be negligible. Also every economist and businessman at this time confidently expected full employment to be the continuing normal condition. The money panics which arose periodically were short lived, and it was believed that they could be eliminated by a better organization of the monetary reserves of the nation and this improved organization was to be provided by the Federal Reserve System being proposed in Congress.

The Federal Reserve System consists of a Board of Governors of seven located in Washington and twelve Federal Reserve Banks distributed throughout the nation. Each of the twelve Federal Reserve banks has a nine-man Board of Directors. The Board of Governors is selected by the President, and his appointments must be approved by the United States Senate. The nine-man Board of Directors of each of the twelve Federal Reserve Banks is divided into three groups of three each. One group of three is selected by the Board of Governors, and it is from this group that the Chairman and Vice Chairman of the Board of Directors must be chosen. A second group of three is selected by the commercial banks holding membership in the Federal Reserve System and located in the district of the Federal Reserve Bank on whose board of directors they serve. The third group of three is also selected by member banks of the district but is chosen to represent business interests other than banking of the district, and customarily one represents agriculture, one manufacturing of mining and one merchandising.

The law gives the President some guidance in his selection of Governors. For example, only one Governor may be selected from each Federal Reserve district, which forces a geographical dispersion. Also the President is advised by the law to include in his selections representatives of major industries other than finance. It is of interest to note that the law does not provide for the appointment of representatives of labour to the Board of Governors.

The powers of the Board of Governors over the twelve Federal Reserve Banks were considerably expanded in the banking legislation of the 1930s. The Board has become the chief policy-making agency of the Federal Reserve System and in addition to the seven board members and their secretaries includes a well-organized statistical and economic research division and a staff to coordinate the work of the commercial bank examiner staff of the twelve Federal Reserve Banks.

Operations of the Federal Reserve System are carried out by the twelve Federal Reserve Banks. The monetary goal of these operations is established by the legislation providing for the Federal Reserve System and by the decisions of the Federal Reserve Board or of System wide committees including representatives of the Federal Reserve Banks and the Federal Reserve Board. By far

the most important function of the Federal Reserve Banks in terms of man hours is the provision of an efficient medium of exchange. Here the principal job is to clear the million of checks which cannot be cleared through local clearing houses. The second job is to keep a flow of currency adequate to fulfill the needs of commerce. The third job which since World War II has grown greatly is the management of the fiscal affairs of the Federal government. This requires the Federal Reserve Banks to act as banker for the United States Treasury, which includes the management of treasury deposits and the sale and redemption of Federal government securities. The operations of the Federal Reserve Banks related to carrying out the monetary policies of the System are, of course, of vital economic importance, but they do not require the quantity of routine operations necessitated by the strictly money exchange and banking functions.

The twelve Federal Reserve Banks are in the following cities (the number indicates the number of the district and the district of each bank includes a definite area contiguous to the city in which the bank is located): (1) Boston, (2) New York, (3) Philadelphia, (4) Cleveland, (5) Richmond, (6) Atlanta, (7) Chicago, (8) St. Louis, (9) Minneapolis, (10) Kansas City, (11) Dallas, and (12) San Francisco. In addition to the twelve Banks, the System includes 24 branch banks.

Over 50 per cent of the assets of the twelve Banks are possessed by three banks: the New York, Chicago, and San Francisco Banks. The New York Bank is by far the largest of the twelve and is credited with dominating the Federal Reserve System until 1935. The Minneapolis bank is the smallest and possesses assets only about one twelfth as great as those of the New York Bank.

The member banks of the Federal Reserve System are the commercial banks of each Federal Reserve district that have met minimum requirements, requested admission, and been admitted. All commercial banks that have a charter granted by the Controller of the Currency, a division of the Treasury Department, are national banks and are required by law to be member banks also.

State commercial banks, banks possessing a charter granted by a particular state banking commission, are free to become members of the Federal Reserve System or to abstain. Nearly all the large

state commercial banks have become member banks. Member banks include about 49 per cent of America's 14 thousand commercial banks. These banks hold about 86 per cent of all commercial bank deposits.

The two greatest deterrents to state bank membership in the Federal Reserve System are (1) the high reserve ratios required of member banks by the Federal Reserve Board and (2) the high capital requirements that must be met by a member bank establishing out-of-town branches. The most important advantage derived by state banks through membership in the Federal Reserve is the attainment of direct access to the discount and loan facilities of the Federal Reserve System.

The funds for the original establishment of the Federal Reserve Banks were obtained through a required stock subscription equal to 3 per cent of the paid-up capital of each commercial bank becoming a member of the System. Today this comprises only one-half of one per cent of the assets of the Federal Reserve Banks and is therefore relatively unimportant; but it still represents the only strictly equity capital, and therefore it is still legally correct to say that the Federal Reserve Banks are owned by the member banks. The stock held by member banks is best compared to non-voting stock of a corporation. In effect, all voting stock of the Federal Reserve Banks is held by the Government through its control over the Board of Governors.

The Federal Reserve System has developed in such a way that the grant of power by Congress to the System which permits the System to purchase and sell government securities, bankers' acceptances, and other designated credit instruments in the open market has become the System's most powerful instrument for the control of the quantity of credit. This activity which is called open market operations can directly affect the reserves of member banks and therefore the quantity of lending activity of commercial banks. These open market operations are conducted by the Federal Open Market Committee which is a joint Board and Bank Committee and consists of the seven members of the Federal Reserve Board and five members representing the Federal Reserve Banks. One of the five Bank members of the Open Market Committee is always selected by the New York bank; the other four bank members represent the four groups into which the remaining Federal

Reserve Banks have been divided for this purpose. By actual vote the Board controls the Open Market Committee, but voting has never been recorded to have been on the basis of Board versus Banks. Actually nearly all recorded votes of the Open Market Committee have been unanimous.

The Board also utilizes committees representing only the viewpoints of the Federal Reserve districts. The best established is the Federal Advisory Council. It is a council of twelve with one selected by the board of directors of each Federal Reserve Bank. The individual selected is nearly always an official of one of the largest commercial banks of each Federal Reserve district. The primary function of the Council is to advise the Board of how commercial bankers feel concerning current monetary problems. This function is only advisory. Another less formal group which meets regularly with the Board consists of the twelve presidents of the Federal Reserve Banks. Their function is also only advisory.

In addition to the use of open market purchases and sales to control the quantity of credit, the Federal Reserve Board, and in these cases without the necessity of officially consulting Federal Reserve Bank representatives, may change the rediscount rate, the reserve requirements of member banks (within limits), and margin requirements (within limits) on all transactions in securities on registered security exchanges.

In addition to its powers for the control of monetary affairs which it continues to possess at the time this is written, the Federal Reserve System has possessed other powers. During World War II and at intervals of inflationary pressure since then, the Federal Reserve Board has had the power to establish the minimum requirements for the extension of consumer instalment credit. The control of consumer instalment credit was provided under the famous Regulation W of the Federal Reserve Board. Here as in the case of margin and commercial bank reserve requirements, the maximum amount of restriction was established by legislation adopted by Congress. During a short period starting with the emergency economic legislation adopted shortly after the outbreak of the Korean War the Federal Reserve Board was given power to restrict the extension of credit to finance the construction of housing. These restrictions were formalized under Regulation X of the Federal Reserve Board.

A final opportunity open to the Federal Reserve Board to control the quantity of credit extended and the direction in which credit flows comes under the idea of "moral suasion". Moral suasion has taken the form of letters to bankers' associations and individual bankers. Also speeches of Federal Reserve officials and articles in publications of the Federal Reserve System have been used to influence credit decisions of bankers in the direction considered most desirable by the Federal Reserve. Special legislation adopted shortly after the outbreak of the Korean War attempted rather unsuccessfully to expand moral suasion into a voluntary program of credit control. The efforts of the administrators of the voluntary credit control schemes to apply the sanctions provided to prevent credit expansion arising from the borrowing of state and local governments caused serious difficulties. The result was a virtual abandonment of this more elaborate program for voluntary control of credit although the legislation providing for it has not been repealed.

The powers granted to the Federal Reserve System in 1913 resulted in a considerable transfer of monetary power from the Treasury, a department of the executive branch of the Government, to the Federal Reserve System, an independent agency. The Treasury was not particularly opposed to this transfer because money problems in those days were arising from operations of the private economy for which the organization of the Treasury was unsuited to deal. The powers granted the Federal Reserve originally and those which it has acquired since its establishment have been aimed at dealing with this type of monetary problem. However, the powers granted were inadequate for the solution of the credit and money problems of the 1930s, and as a result, some of the Treasury monetary responsibilities that had been transferred to the Federal Reserve in 1913 were returned to the Treasury in the banking legislation of 1933 and 1935, in addition, the Treasury was granted some new monetary powers aimed at the elimination of deflation. It was believed at this time that the new legislation added to the basic powers of the Treasury would return monetary dominance to the Treasury. This was the situation, however, only if deflation continued to be a problem and if a free money market would result in satisfactory monetary policy. As is well known this was not the postwar situation, and as a result, monetary power was distributed differently in the 1940s

and 1950s than had been expected by the writers of the monetary legislation of the 1930s.

The monetary powers of the Federal Reserve System excluding the control over margin requirements and the temporary powers acquired during World War II and the Korean War are sufficient only to control conditions existing in the money market. The possession of this power by the Federal Reserve did not appear to be particularly important in the 1930s; however, the changed conditions of the war period made it very important. The new importance of control over the money market arose from a shift to generally inflated conditions from a condition of deflation and in addition the necessity of controlling the money market to meet the management demands arising from the terrific expansion of the size of the Federal government's debt.

Since 1946 the most important factor affecting monetary conditions in the United States became the value the money market placed upon government securities. The management and control of this market was definitely within the domain of the Federal Reserve. In addition, the Treasury found that the new monetary powers which it had been given in the 1930s were useless under conditions of general inflationary pressures. The effect has been to return to the Federal Reserve System the possibility of dominance in the establishment of monetary policy which was originally envisaged in 1913. However, in the post-war period the Treasury has not shown the same willingness to accept Federal Reserve dominance that it had demonstrated in 1913. The justification for the different Treasury attitude is not difficult to find or understand and rests basically on 'the proposition that current monetary problems are arising from government credit actions rather than private activity. In this area the Treasury considers itself to be more suitably organized to meet the monetary problems involved than is the Federal Reserve System.

The procedure to be used in the management of the money system of the United States is apparently at a crossroad.

The Federal Reserve System is organized to manage a monetary system which is affected nearly entirely by credit decisions of the private economy functioning under conditions of prevailing full employment. It is not suitably organized to avoid serious deflationary conditions as was shown by developments of the 1930s or to

avoid inflationary conditions arising from credit decisions of the Federal Government as was shown by the postwar experience. The Federal Reserve System through its control of the money market continues to possess the legal power to stop inflationary developments from whatever source, but actually it is rather impotent if the inflationary pressure is arising from Treasury debt management policy. The impotency arises from a provision in the legislation establishing the Federal Reserve System requiring it to assure placement of all indebtedness of the Federal government. Under these conditions the Federal Reserve Banks must make open market purchases of securities which may be offered by the Treasury but which do not find private buyers. The Federal Reserve Banks can prevent the Treasury from forcing them to enter into inflationary open market purchases only if the Federal Reserve Banks are willing to sell as large a quantity of other securities held as they purchase of new Federal government securities offered. This is actually what the Federal Reserve officials did in the Fall of 1950 which forced the accord of March 1951. At best the "accord" is a temporary arrangement and will break down any time voluntary cooperation between the Treasury and the Federal Reserve System ceases.

The new conditions of the dominant Treasury interest in the money market due to the huge unfunded Federal government debt has made the Treasury very sensitive to money market changes. However, the Treasury's powers are not suitable for controlling the money market. The Federal Reserve System is suitably organized to control the money market but its responsibilities were originally developed under quite different conditions. The development of suitable institutional arrangements for monetary management under the new conditions of a greatly expanded government debt and general expansion of government economic activities is the sole responsibility of Congress. In an effort to fulfill these responsibilities the Joint Committee on the Economic Report has established two subcommittees during the past six years to study the problem. These subcommittees under the leadership of Senator Douglas and Congressman Patman respectively held long and informative hearings. However, substantial legislation aimed at a reorganization of the American institutional arrangement for the establishment of monetary policy has not been enacted.