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The Structure and Functions of the Federal Reserve System of the United States Today

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3rd Prize

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by

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Preface

In writing a paper on the Federal Reserve System of the United States which is not to be encyclopedic in scope, the writer must face the problem of what to exclude. Without defeating the purpose of this paper,which is to give the reader a clear and concise understanding of the main points that enter into the structure and functions of the Federal Reserve System of today. The writer has seen fit to omit a general discussion of the Federal Reserve Act of 1913 and all of the amendments which have effected the Act in these twenty five years of operation. Instead he shall confine himself to the study of the system as it is now in use and give to the reader a picture of the structure and functions of the System.

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Introduction

With the exceptions of the Declaration of Independence and the Constitution of the United States,the Federal Reserve Act which was signed by president Woodrow Wilson on December 23,1913, may possibly be the most important piece of legislation ever passed by a Congress of the United States[1]. Upon the wise administration depends the welfare of over 120,000,000,000 people, and as a nation we shall probably live under its laws, subject of course from time to time to amendments that will be found necessary to meet future unexpected needs of the times.

The miraculous thing about the creation of the Federal Reserve System is that it sprang forth in a few hours before the Christmas holidays from a new Congress that knew little about currency and less about banking,and an Executice and cabinet that made no pretense of having any knowledge concerning principles of finance. Still,if that Congress had been composed of financial experts, and the Executive and cabinet had been banking experts, it probably could not have given us a better Act.

That Congress having no set principles, thus being unprejudiced, gave to us a Federal Reserve Act which was a re-formation of an unworkable andchaotic measure passed by the House. It was forced into shape by pressure from the Administration for Congress to pass some plan immediately. Yet this act was in its broad principles, the result of expert currency and banking agitation that had been going on for over a generation before the panic of 1907 had emphasized the need for currency legislation. I

1-H.L. Moulton,Principles of Money and Banking,Chicago;
University of Chicago Press,1916,p.331

Singular as it may seem,the force,breadth,and character of the act itself was due to the pressure of the Administration,as already mentioned, for an act before the adjournment for Christmas holidays. At the very last moments of the session the points in disputes were settled and the Act was passed.

Thus that act placed in the hands of the Secretary of the Treasury and the Federal Reserve Board the construction,regulation,and government of a reserve system of banking to be built out of the reserves of the national banks,gradually mingles with the capital subscribed by the national and member banks, and gradually removed from the central reserve system cities. The whole system was to be knitted together at home and abroad,with power in the Federal Reserve Board to expand or contract the currency at will,to officer and regulate, and name the discount rate of the member and Federal Reserve Banks.[2]

How has the Federal Reserve System grown since that cold day in December in 1913? Has the Act been amended,or is it still intact? Naturally it would take too long to tell of all the changes,minor and important alike, so the writer will be content with giving a discussion of the main points in the structure and functions of the Federal Reserve System that are now effective. In this way the reader can best understand the system without being bored by a discussion of a long list of amendments and how they effected the system.

2-Ibid, p.332

Structure

As originally provided for in the Federal Reserve Act of 1913, the Federal Reserve Board was to consist of seven members appointed by the President of the United States Directly as members of the Board. Two of these were only ex-officio as they were to be the Controller of Currency and the Secretary of the Treasury. To reduce the dangers that these political appointees might abuse the powers they possessed over the banking system, The Federal Reserve Act required that two of the appointees be persons of some banking or financial experience.

Aside from the specific requirement concerning the two persons who should have banking experience, the original act required that all members be selected with "due regard to a fair representation of the different commercial, industrial, and geographical divisions of the country." In 1922 the law was amended. The specific requirement that two members be persons of banking experience was omitted and agricultural interests were included in the list of interests entitled to fair representation. This change was made upon the insistence of the "Farm bloc" that agriculture was not being given fair consideration in the policies of the Federal Reserve Board, and that a "dirt" farmer should be appointed to membership on the Board. To make room for such a mamber the total membership of the Board was increased to eight, a rather non-sensical procedure, since, without giving any particular power to agricultural interests it gave the Board an even number of members, thus bring the danger of a deadlock upon important questions of policy. [3]

3- L.A.Rufener, Money and Banking in the United States. Boston; Houghton and Mifflin Co., 1934, p.478.

In order to ensure some measure of continuit of policy,the term of office of the appointive members of the Board was made ten years, and of the first five appointed one was to serve two years, one four,one six,one eight and another ten years,so that thereafter one new member would be appointed every two years. This method of appointing members made it unlikely that a complete change in membership of the Board would take place with a change in the political party in power and reduce the probability that politicalconsiderations would influence the actions of members. On the othar hand,the inclusion of the Controller of the Currency and the Secretary of the Treasury as mambers of thé Board increased the menace of politics because it practically ensured the appointment of a majority of the members of the Board by the President during a four-year term. Moreover, the fact that the Secretary of the Treasury was designated by law as the Chairman of the Board brought the danger that the exigencies of the Treasury might be set above sound banking policies and public welfare in time of political stress. This danger was not made less by the great political power and social prestige which belongs to the Secretary by virtue of his office, and through which he/may dominate and even intimidate the lesser members of the Board.

The Federal Reserve Board is authorized and empowered to exercise general supervision over the federal reserve banks and over all members banks of the Federal Reserve System. At its discretion it may examine the accounts,books and affairs of each reserve bank and of each member bank, and require such statements and reports as it may deem necessary. It may suspend or remove any officer or director of any reserve bank for just cause, and, for vèolation of any provision of the Federal Reserve Act,it may suspend the operations of any federal reserve bank,take possession of and administer the bank during such suspension, and when deemed advisable, reorganize or liquidate it.

The Federal Reserve Board supervises and regulates, through the Treasury bureau under the charge of the Controller of Currency, the issue and retirement of Federal Reserve Notes, and it exercises a large measure of control over the discounting operations of the federal reserve banks, in respect both to the rate of discount and the paper elegible for the purposes of discounting. Although the provision of the law have not been discussed in detail, still enough has been said to indicate that the Federal Reserve Beakd is a most powerful and administrative body, able, if itspower is used, to exercise a large degree of control over the entire system of banking in this country.

In respect to details of administration, the board is empowered to employ such attorneys, experts, assistants, clerks or other employees as may be found necessary for the conduct of its business. The appointive members are required to devote their entire time to the business of the board, and as government salaries go are liberally awarded for their services. To defray its expenses the board is empowered to levy seni-annually upon the federal reserve banks an assessment in proportion to their capital stock and surplus. Since the federal reserve banks must pay their own expenses too, the entire system is self sustaining, and is not supported at the taxpayer's expense.[4]

Federal Reserve Banks.

Under the federal reserve system now in effect today we have twelve federal reserve districts. In each one of the districts we have one bank

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4- Ibid. pp.48-482.

which is the Federal Reserve Bank in its district. The general purpose of these federal reserve banks may be said to serve collectively as the central banking mechanism of the country, and individually as banker's banks for the member banks of their respective districts.[5]

Each of these Federal Reserve Banks is governed by a board of nine directors, of whom three are appointed by the Federal Reserve Board, while the other six are elected by the stockholders of the reserve bank itself. The stockholders are the member banks. Of the six directors elected by the member banks, three are to be representives of banks and presumably bankers themselves, and the other three are to be actively engaged in commerce,agriculture, or some other industrial pursuit. The first three are called class A directors, and the other three are called class B. directors. Those appointed by the Federal Reserve Board are called class C. directors.The Federal Reserve Act specified in some exactness the method for election so that one class A and one class B director is appointed by each of the three divisions of banks in the district,namely; large,medium, and small member banks in the district. These divisions are also fixed by the Act in accordance with the capital stock of the bank.

The class C directors, who are appointed by the board, shall have been at least two year's residence of the district for which appointed, and one of these, who must be a person of tested banking experience, is designated by the board to serve in a dual capacity. He serves as chairman of the Federal Reserve Bank Board of his district and also serves as the Federal Reserve Agent. In this latter capacity he maintains a local office of the Federal Reserve Board on the premises of the reserve bank. [5]

5- Ibid.p. 893.

In summarizing the organization of each Federal Reserve Bank we may note that among the nine directors there are four bankers,including the federal reserve agent. Three members of the board represent government; and three represent business other than banking,but since six members are chosen by the nanks, it is obvious that banking interest will dominate the board, and if reserve banks are not soundly managed, it is because the banksers who control them are either ignorant of sound banking principles and practices, or choose to ignore them,or have unsound policies forced upon them by the Federal Reserve Board.

Federal Advisory Council.

One line of communication between the Federal Reserve Board and the federal reserve banks was provided for through the Act of 1913 through the provision already discussed regarding the appointment of the three directors of each reserve bank by the board itself. A second line of communication,running,one might say, in the opposite direction, was provided for through the information of the council known asthe Federal Advisory Council. This council consists of twelve members, one elected by the board of each federal reserve bank. It is directed by law to hold at least four meetings a year in Washington, and oftener, if called by the Federal Reserve Board. In addition it has the power of holding additional meetings on its own initiative in Washington or elsewhere whenever the Council deems the meeting a necessity. As its title indicates, the duty of the Federal Advisory Council is purely of the nature of advising the Board,and of serving as a line of communication between the Board and the Reserve Banks.

6-Ibid.p.494.

Governors of the Reserve Banks.

In addition to the two lines of communication between the reserve banks and Federal Reserve Board that were established by the Federal Reserve Act itself, a third and very unexpected line of communication has grown and established itself as a line of some importance.

The governors of the federal reserve banks,as such, were not named in the Federal Reserve Act of 1913. But as the Federal Reserve Board interpreted the law, it was the intent of Congress that each of the twelve federal reserve banks should have a chief executive officer other than the chairman of the board. This officer was to correspond to the president of an ordinary commercial bank. The title of Governor was chosen for two reasons: First, it made the management of the Reserve banks correspond to the form of organization of the Board itself, and second, the title of governor would distinguish the officer from the office of chief executives of ordinary banks, namely, that of president.

This governor may be chosen from among the directors of the reserve banks, or he may be brought from the outside. It has now become customary to choose men from the outside, so that ordinarily the governor does not sit on the board of directors of the reserve bank. Since the reserve banks have naturally desired to have men of great banking reputation as their governors, they have offered salaries commensurate in some degree with the abilities of the men they have desired to attract. As a consequence the governors of the reserve banks

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have tended to be men of great reputation, more commanding personalities, and higher salaries than the federally appointed chairman of the Board, and have tended to become the dominating figures in their respective banks.

The Federal Reserve Board has gradually shifted its methods of communication with the reserve banks from the reserve agent as chairman of the board of the reserve banks to the governors of these reserve banks. It was not long before it was found to be desirable for the twelve governors to hold meetings to discuss matters of common interest and to obtain some degree of uniformity in the conduct of their banking operations, particularly in relations to the open-market operations. So there has now been established an institution known as the Conference of Governors. This institution has tended to overshadow in importance the Federal Advisory Council, and even to usurp some of the functions of the Federal Reserve Board.[7]

As to the organization of the member banks very little need be said. The member of the Federal Reserve System consist of all national banks, membership of this type of bank being compulsory, and all state banks, trust companies, and private banks in the district which are able to meet the specified requirements as to capital, cash reserve, and other requirements that the Federal Reserve Board should deem necessary. Other than the national banks, membership is obtained by willingness to join, an not by compulsion.

Each bank is organized in the same way as if it were an ordinary bank not belonging to the Federal Reserve System.

7-W.L.Willis, The Federal Reserve System. New York; Ronald Press, 1923, p. 234.

By way of completing our survey of the structure of the Federal Reserve System, we may say that this system consists of a Federal Reserve Board, the twelve federal reserve banks, the Federal Advisory Council, the Conference of Governors, and the member banks. The Federal Reserve Board consisting exclusively of men appointed by the president of the United States. The federal reserve banks are privately-owned banks, their stock being held exclusively by the member banks, and each bank being governed by a board of nine directors, of whom six are elected by member banks, and the other three appointed by the Federal Reserve Board. The member banks consist of all banks which meet the requirements of membership as designated by the Federal Reserve Board, and all National banks? The Federal Advisory Council consists of bankers exclusively, and the last part, the Council, or rather the Conference of Governors, which by virtue of the position of its members is a most powerful body, in some respects even more powerful than the Federal Reserve Board itself.

Function of the Federal Reserve System.

A discussion of the functions of the Federal Reserve System revolves itself largely to a discussion of the main functions of the federal reserve banks in their relation to the member banks on one side and the Federal Reserve Board on the other side. I shall then be content with giving these main functions of the federal reserve banks as they will in the end be the most prominent functions of the Federal Reserve System in its entirety.

The first function of the federal reserve banks is to act as a depository for the reserve of its member banks. In the Federal Reserve Act as originally passed by Congress the member banks were divided into three groups according to their location. Those located in New York or Chicago were classified as banks in "Central Reserve" cities, those in some sixty of the largest cities as banks in "Reserve" cities, and the other banks were classified as "country" banks. The proportion of the demand deposits which were required to be kept in the reserve banks as reserves were originally 18%,15% and 12%, according to the classification of the banks. These provisions were entirely recast by an amendment to the Act June 22,1917,soon after the entrance of the United States into the World War. Under this amendment the reserve requirements were reduced to 13%,10%,and 7%, respectively.

Whenever the reserves of a member banke are running low and it becomes necessary to replinish them, two courses of action are open to the member bank; it may send cash items for deposit with its federal reserve bank, or it may borrow from the latter the additional reserves that it needs. [8]

8-W.H. Kiekhofer; Economic Principles, Problems and Policies. New York; D.Appleton-Century Co., 1936,p. 330.

A second function of the federal reserve banks is the rediscounting of commercial paper. The Federal Reserve System may be described as a measure for introducing the redicounting central banking system, to the world. One of the primary functions of the federal reserve banks is this function of rediscounting eligible paper for its member banks. By eligible paper is meant the bills drawn for "commercial,agricultural,or industrial purposes," but it does not include those bills drawn merely as investment securities,except bonds and notes of the United States Government. Apart from the last-named ominous exception, the test of eligibility of the paper is the surplus of "quick assets" possessed by the borrower who originally raised money on it. In America the banking accomodations given to internal trade take the form neither of bills of exchange,nor of simple advances,but rather of promisoory notes.

A large portion,perhaps the majority, of these notes are eligible for rediscount,and the right of rediscount has made the position of the ordinary United States bank far more liquid than before.

If a member bank so desires, it may take the proceeds of the rediscounted loan as a deposit credit rather than as cash. If in need of building up its reserve with the federal reserve bank, it will ask for, and receive deposit credit. [9]

A third function of the federal reserve bank is to act as a clearing house, not only for banks belonging to the federal reserve system,but also to any banks that are not members of the system,but who so desire the action of the federal reserve banks as clearing houses for them.

9- B.C. Hartrey,Monetary Reconstruction,New York; Ginn and Company,1934;,p.96.

The substitution of reserves deposited with the federal reserve banks for reserve held partly in cash and partly on deposit with the national banks has been logically accompanied by a reform in the clearing system. An endevor has been made, with considerable success, to concentrate the clearings in the federal reserve banks, which, it may be well to mention, have a number of branches. Subordinate centers still exist, central banks still carry balances in the central national banks, but these balances no longer count as reserves, and as all member banks in any cases have balances in the federal reserve banks, the old heirachy of clearing houses has lost its importance. The Federal Reserve System has established a system of clearing cheques from all over the country, as nearly as possible free of charge, even for non-member banks who choose to participate in it.[10]

A fourth function of the federal reserve banks is that of engaging in open-market operations. Section fourteen of the Federal Reserve Act authorizes the federal reserve banks to engage in the following specific operations:

> 1. To buy and sell in the open-market, at home and abroad, cable transfers, bankser's acceptances, and bills of exchange which are eligible for rediscount under a previous section number 13.
> 2. To buy and sell, at home and abroad, gold coin and bullion.
> 3. To buy and to sell, at home and abroad, bonds and notes of the United States, and bills, notes, and warrants, with a maturity not exceeding six months, issued by states and municipalities of the United States in anticipation of receipts of revenue.

These open-market operations were expected to achieve several important purposes. They would enable the federal reserve banks to find profitable use for funds not employed in making advances to member banks.

10- *Ibid.* p.97.

Second, the power given to the reserve banks to buy and sell banker's acceptances and trade acceptance in the open market would permit them to take an active part in developing a market for these two types of paper, and thereby make them more popular instruments of ~~ixs~~ investments among commercial banks, member and non-members alike. However, only the banker's acceptances have become of any value, the trade acceptances failed to thrive because they served no important purpose. [11]

The fifth function of the federal reserve banks is to act as a depository for the government, and also to act as its fiscal agent. Under the Federal Reserve System the problem of what to do with government funds has been solved. The reserve banks have been made the chief depositories of United States funds. When, for example, a man pays his income tax, he writes out a check payable to the Government or its agent, and this check is deposited in a federal reserve bank to the credit of the government.

Under this system the operations of the government do not contract or expand the available quantity of money in circulation, nor the amount of bank credit as a necessary result of differences in government receipts and expenditures. If excess receipts drain funds out of the member banks into the reserve banks, by that very fact the reserve are placed in a stronger position to expand loans to member banks if loans are required.

11- Rufener, Op. Cit. p. 524.

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The sixth and last of the main functions of the federalreserve banks as expressly stated in its title..."To furnish an elastic currency". This is a function which is intimately related to that of rediscounting. Before the passage of the Federal Reserve Act of 1913 there was no elasticity in our currency because the national bank notes were backed by gold bullion which of course is very inelastic.

Under the Federal Reserve System of the Federal reserve banks have the power of issuing two types of legal tender. This power was given in order that there be issued a type of legal tender to replace the old national bank notes. The first of these are the Federal Reserve Bank Notes. These are of little importance and merely replace the National Bank notes. Like the notes which they replaced, they are backed entirely by gold bullion.

The important issue is that of the Federal Reserve Notes. These notes are ultimately obligations of the United States Government, but are issued by the reserve banks, and become liabilities of the issuing bank. They are in reality not legal tender, but are convertable into legal money upon presentation at the issuing bank. They are issued to federal reserve banks in exchange for either eligible paper or gold. Eligible paper and gold of course being the principle assets of the federal reserve banks. Thus the federal reserve banks are able to meet any demands which could possibly be made upon them for currency. The federal reserve banks are thus fully equiped to supply the member banks both with the credits which constitutes their statutory reserves and clearing house balances, and also with currency to meet the demands of circulation.[12]

12-F.B.Garver and A.H.Hansen, Principles of Economics, New York; Ginn & Co. 1928, p.323.

To ensure the maintenance of our mometary standard,they are reqiired to keep at least sixty per cent lawful money as backing against the federal reserve notes issue. They must also have a backing of forty per cent gold bullion. Thus with a backing of one hundred per cent the safety of this type of note issue in unquestioned. The reserve requirements can be suspended, subject to a payment of a graduated tax by the federal reserve bank. [13]

In a brief summary of the functions of the federal reserve banks and the entire federal reserve system we find that the federal reserve system performs the following important finctions: First, acts as a depository and fiscal agent of the federal government, second, rediscounts commercial paper,third,acts as a clearing house for all banks in the country,fourth,enganes in open-market operations, fifth, acts as a depository for the member banks of the federal reserve system, and sixth, the primary and most important function of the entire system,maintains an elastic currency by means of the issuance of Federal Reserve Notes.

If we review the past experience in these twenty five years that the system has been in operation we shall find that the Federal Reserve System has conferred an incalcuble benefit upon America, in ~~in~~ that it has successfully set up an authority with the special duty of exercising fore-sight and initiative in the regulation of credit. The Federal Reserve Bank, which is a judicious lend of government and of business representatives, had discharged its function during a period of unexapled difficulty with such skill and with such public spirit as to gain the confidence and good will of the banking world. [14]

13- Ibid.p.323.
14- Moulton,Op.Cit. p.120

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