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SOME EFFECTS OF THE FEDERAL RESERVE SYSTEM ON THE AMERICAN ECONOMY

BURNETT B. COURSEY

1959

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ON THE AMERICAN ECONOMY

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A Thesis

Presented to

the Faculty of the Graduate School

Prairie View Agricultural and Mechanical College

In Partial Fulfillment

of the Requirements for the Degree

Master of Arts

by

Burnett B. Coursey

August, 1959

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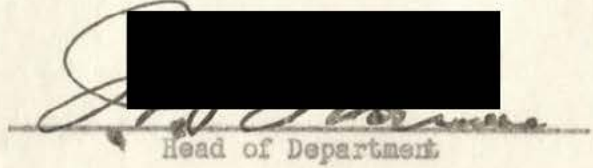

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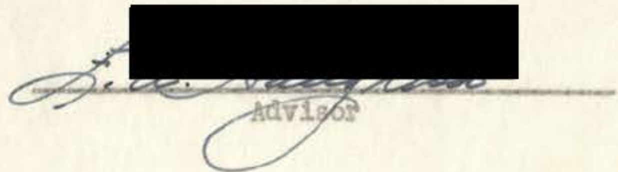

Advisor

August 12, 1959

Date

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during the period of this research.

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DEDICATION

This thesis is dedicated to
Mrs. Ollie Jennings, my mother, for her
inspiration and encouragements.

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CHAPTER I

INTRODUCTION

The Federal Reserve System is considered by many people to be a mysterious organization because most people have only a vague idea of the functions and operations of the Federal Reserve System.

The purpose of this study is to study the organization of the Federal Reserve System and to investigate the effects that the system has upon the American economy.

In seeking the origin of the reform legislation known as the Federal Reserve Act of 1913, the economic historian usually begins with the year 1893. It was that year that the panic and the depression brought to American bankers, businessmen, and statesmen a realization of the weaknesses of the American banking system. In a very real sense, the people of this country began to look in the direction of foreign systems to discover the reasons for their superiority. The complacency which had marked American banking thought was severely shaken.

There was in operation a so-called state banking system and a national banking system, but the fact that there were two banking systems rendered impossible the existence of that degree of organized and coordinated regulation and practice that the

term system implies. The state banks obtained their authority from the state governments in which they were located, and although there was considerable uniformity as to the banking laws of the several states, the differences prevented an identity of policies and practice that is necessary to a smooth working national system of banks. The national banks were chartered under one basic law, but each one was more or less autonomous. No centralized authority could compel these banks to cooperate for the common good of all the banks or the public. Moreover, national banks were given permission under certain conditions to alter their policies and practices so as to compete on equal grounds with the state banks. While these departures from the general rules of the national banking laws were comparatively minor, they did contribute further to the lack of uniformity that already existed.

Some of the more obvious defects and weaknesses relating to banking before the passage of the Federal Acts of 1913 were:

1. Inadequate control of bank reserves. This weakness resulted from the practice by national and state banks of keeping only the part of their reserves on hand that was required; the rest was deposited in another bank, which, in turn, might send part of it to still another bank. When large sums of money were called for, purchasers of securities or commodities

were often forced to sell their holding in such large amounts that prices on the exchange market were adversely affected. If for no other reason than that it produced a feeling of general uncertainty as to the prospects of business, the depression of the organised markets had its repercussions in many phases of business.

2. Inelasticity of Note Issues. It was often said that instead of being elastic, the volume of national bank notes was often perversely elastic--that the volume fluctuated directly opposite to the needs of the public for money.

3. Lack of a National Clearing System--prior to the establishment of the Federal Reserve System in 1914, there was no national organization that could be used for clearing checks. As a result, each bank made the clearing arrangement that it considered the most convenient without regard to the interests of the drawers or payees of checks and other negotiable instruments.[1]

These conditions produced a dilemma in financial conditions in the United States. To further illustrate the situation, I will go further into the dilemma.

When banks throughout the country were pressed for funds by their depositors and borrowers, the demand for credit converged on a few banks situated in the financial centers.

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[1]James Harvey Dodd and Carl W. Hasek, Economic Principles and Applications, 2nd edition. (Dallas: South-Western Publishing Company, 1957), p. 40.

In ordinary times the demand was not excessive, for while some out-of-town banks would be drawing down their balances, others would be building theirs up. But at times when business was unusually active and the public was in need of larger amounts of currency for hand to hand circulation, the demand for money on city banks became widespread and intense. Each year credit demand was particularly strong during the crop moving season. At such times banks all over the country would call on banks in the financial centers to supply funds.

Because no facilities were available for providing additional funds, including currency, the credit situation would become very tight. To meet the out-of-town demand for funds, the banks in the financial centers would sell securities and call loans or would refuse to renew existing loans or make new ones. As a result, security prices would fall, loans would have to be liquidated, borrowing from banks as well as other lenders would become difficult and interest rates would rise sharply. Every few years, difficulties of this kind would lead to a monetary crisis.

The problem had been under public discussion and study for a long time when, following a crisis of unusual severity in 1907, Congress appointed a National Monetary Commission to determine what should be done. After several years

of thorough consideration, Congress eventually adopted legislation embodying the results of study by the commission and other authorities. This legislation was the Federal Reserve Act. It became law on December 23, 1913, and provided machinery by which varying demands for credit and money by the public could be met.

All of the principal nations have reserve banks, sometimes called central banks, to perform functions corresponding to those of the Federal Reserve System. In England it is the Bank of England, which has been in existence since the end of the seventeenth century; in France it is the Bank of France, established by Napoleon I; in Canada it is the Bank of Canada, which began operations in 1935. In the United States there is a regional system of twelve Federal Reserve Banks. Their activities are coordinated through the Board of Governors in Washington.

Before we go into the organization of the Federal Reserve System, it would be proper to deal with the functions of the system. The principal function of the Federal Reserve System is to regulate the flow of credit and money. Other functions include the performance of services for the member banks of the Federal Reserve System, the United States Government, and the public. These services include the following: handling member bank reserve accounts, furnishing currency for circulation and making currency shipments; facilitating the clearance and collection of

checks; effecting telegraphic transfer of funds; acting as fiscal agents, custodians, and depositaries for the treasury and other governmental agencies; and collecting and interpreting information bearing on the economic and credit situation. In addition the Federal Reserve examines and supervises State Member banks, obtains reports of conditions from them, and cooperates with other supervisory authorities in the development of policies conducive to a system of strong individual banks.

CHAPTER II

ORGANIZATION AND STRUCTURE OF THE FEDERAL RESERVE SYSTEM

The purpose of the Federal Reserve Act was not to create or provide for an entirely new system of commercial banks. Rather it was to create facilities that would enable the existing banks to overcome or remove the defects in their practices that had been generally recognized by all students of banking.

The Federal Reserve System is composed of five elements:

1. The Board of Governors
2. The Federal Open Market Committee
3. The Federal Advisory Council
4. The Federal Reserve Banks and their branches
5. Member banks of the Federal Reserve System

The Board of Governors of the Federal Reserve System, as of February 1, 1936, supplanted a similar supervisory agency, known as the Federal Reserve Board, which was provided for in the original legislation of 1913. It possesses many specified powers as well as the authority to exercise general supervision

over the entire system. The board is composed of seven members who are appointed by the President with the advice and consent of the Senate. The term of office is fourteen years, although the original members of the Board of Governors were appointed for "staggered" terms--one for two years, one for four years, one for six years and so on--so that one member would leave office every two years. A member who serves a full term of fourteen years is not eligible for reappointment. The President designates one member as chairman, and one as vice chairman; these offices are held for four year terms, with the possibility of reappointment.

The Federal Open Market Committee is an important agency in the structure of the Federal Reserve System, since it has the power to determine when and in what volume the twelve reserve banks will engage in the purchase and sale of securities. Such purchase and sales are now recognized to be the most important means at the disposal of the reserve authorities for the control of monetary expansion and contradiction.

The Federal Open Market Committee is now composed of the seven members of the Board of Governors and five representatives of the reserve banks. One representative is chosen annually by the Federal Reserve Bank of New York and one by each of the following

groups of reserve banks: Boston, Philadelphia and Richmond; Cleveland and Chicago; Atlanta, Dallas and St. Louis; and Minneapolis, Kansas City and San Francisco. The board of directors of each reserve bank has one vote in choosing the representative of its group, and only reserve bank presidents are qualified for election. Another president or vice-president is chosen by each group as alternate.

Any member of the Federal Open Market Committee may be elected as its chairman or its vice-chairman; these officials are chosen by the members at the first meeting each spring to serve for the current year.

Federal Advisory Council

The Federal Advisory Council is composed of twelve members, one chosen annually by the board of directors of each reserve bank. The members are usually distinguished commercial bankers who are chosen because of their prominence in the representative districts. The reserve banks may vote them a stipulated compensation, with the approval of the Board of Governors, but the office is primarily an honorary one.

Federal Reserve Banks and Branches

The principal operating units of the Federal Reserve System, other than the member banks, are the twelve reserve banks

and their branches. A reserve bank is located in an important city in each of the twelve districts originally delimited by the organization committee, and some twenty other cities are directly served by branch banks established to facilitate the operations of the parent reserve banks. Each bank originally given a twenty year charter by the federal government, but the charters were made of indefinite or perpetual duration by legislation adopted in 1927.

The Federal Reserve Act requires each reserve bank, at the time of its organization to have a minimum subscribed capital of $4,000,000, divided into shares of $100 per value. The stock is subscribed by the member banks into an amount equal to six per cent of their own capital and surplus, although only one-half of each subscription must be paid in, the balance is subject to call.

The Federal Reserve Act authorizes the Reserve banks to pay a cumulative dividend of six per cent upon the paid in stock held by the member banks. Under no circumstances, can the stock holding member banks enjoy a return exceeding that rate.

Board of Directors

Each reserve bank is managed by a board of nine directors who are chosen in part by the Board of Governors and in part by the member banks. Three of the board members, known as Class A directors, are designated as the representatives of

the banking interests of a reserve district; and three, the Class B Directors, represent the commercial, industrial and agricultural interests of the district. Directors of these two types are elected by the member banks. The Class B directors must not be officers, directors, or employees of any other banking institutions. The Class C directors, also three in number, are appointed by the Board of Governors to represent the public interest. They must have been residents of their respective districts for at least two years preceeding their appointment. The term of office for all directors is three years.

The chief executive officer of a federal reserve bank is the president; he is chosen for a term of five years by the bank's board of directors, subject to the approval of the Board of Governors. One or more vice-presidents may also be selected, and the appointment of the first vice-president is also subject to the approval of the Board of Governors.

Branches

Twenty-four branches of the federal reserve are now in operation. In several instances, branches were established apparently to assuage the injury felt by some major cities because they were not designated as the location of parent banks; and in some cases, their establishment was more clearly designed

to provide better facilities to serve the member banks. Branches are especially useful in speeding the clearing and collection of checks, particularly in the districts west of the Mississippi River, which comprise vast areas. The branches are not independent institutions, they may be thought of as divisions of their parent banks.

Powers of the Board of Governors

Some of the powers other than those already mentioned are as follows: The reserve banks are required to submit to the Board of Governors a weekly statement of their financial condition. The board may require them to write off any assets it considers worthless. The reserve banks are examined periodically by a group of examiners, under the direction of the Board of Governors.

Member Banks

All national banks are required to be members of the Federal Reserve System. Incorporated state banks, including commercial banks, mutual saving banks, trust companies and industrial banks (such as Morris Plan Companies), many voluntarily join the Federal Reserve System if they are able to satisfy the qualifications for membership. Other state chartered institutions,

such as savings and loan associations, sales finance companies, are not eligible for membership.[2]

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[2]Raymond Kent, Money and Banking. (New York: Rinehart and Company, Inc., 1951), p. 80.

CHAPTER III

THE MEANS AND WAYS OF INFLUENCING THE AMERICAN ECONOMY

The Federal Reserve has three general means of influencing over all credit and monetary conditions. These general means are discount operations, open market operations and changes in reserve requirements. The writer feels that each of these means should be discussed individually. A short discussion on selective credit regulation and moral suasion will also be presented.

Discount Operations

Commercial banks have the privilege of borrowing from the Federal Reserve Bank. This may be done by two ways. First, the bank may rediscount one of its own customer's notes with a Reserve Bank and second, it may give its own note to a Reserve Bank using paper from its own holdings as collateral. For these services the Federal Reserve charges interest at a rate known as the discount rate. The discount rate is simply the interest rate charged by the Reserve Banks on their loans. When discount rates are increased this increases the cost of acquiring reserves by borrowing, whereas a decrease in discount rates make it easier for a bank to acquire reserves this way.

These discount rates are ordinarily initiated by the board of directors of the twelve Federal Reserve banks, but are subject to the approval of the Board of Governors. These rates are submitted to the Board of Governors every fourteen days for approval. The board could require this to be done oftener, but does not under ordinary circumstances.

Discount rates can differ at the various Reserve Banks and they sometimes do. But they are usually the same, and the occasional differences are usually small and short-lived.[1]

Open Market Operations

It may be said that open market operations differ radically as a means of influencing the flow of credit and money. They differ in that open market operations are initiated by the Federal Reserve and not by member banks. In the case of discounts, the Federal Reserve establishes a discount rate at which member banks may obtain Reserve Bank credit for appropriate uses if they apply for it. The decision is left to member banks.

Open market operations present a different situation. The Federal Reserve can proceed of its own accord to buy or sell

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[1]Lester V. Chandler. The Economics of Money and Banking. (New York: Harper and Brothers, 1959), p. 105.

securities in the open market. These operations take place only if the Reserve Bank feels that the flow of credit is too sluggish or too active. Government bonds are the principal kind of paper with which the Federal Reserve can expand their loans, investments and deposits.

The procedure takes place in this manner. If the Federal Reserve decides to reduce reserves and thus restrain credit and the growth of the money supply, it sells government securities to a dealer. This dealer may hold them or sell them. When the dealer pays for them, he draws a check on some member bank in favor of a Federal Reserve Bank and the Reserve Bank deducts the amount from the reserve deposit of this bank. The banks then have to adjust their lending policies to their reduced deposits and credit will be restricted.

Federal Reserve open market operations are controlled by the Federal Open Market Committee. The committee is composed of the seven members of the Board of Governors, the president of the Federal Reserve Bank of New York and four other presidents of Reserve Banks. This group meets in Washington at least every three weeks, and its members communicate with each other more frequently, often by telephone. This group prescribes open market policy, setting the aims and prescribing in a general way the nature and magnitude of the operations to be taken.

Two aspects or parts of these operations should be emphasized. (1) The open market transactions occur in New York City, but their effects are by no means confined to this area. (2) The most powerful effects of the Federal Reserve purchases and sales are achieved through their impact on the reserves and lending power of the banks, whether these operations are with banks or others.[2]

Changes in Reserve Requirements

The means discussed earlier, discounts and open market operations, by the Federal Reserve System add to or subtract from the funds available as member bank reserves. When reserve requirements are changed it does not directly alter the total of reserves. Instead it changes the proportion of a member bank's deposits that must be held as reserves with a Federal Reserve Bank. Therefore, the liquidity position of the bank is affected, thus affecting the amount available for loans or investments.

An illustration will probably make the situation clearer. If the reserve requirement against demand deposits is 15 per cent, a member bank must keep in its reserve account with

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[2] Ibid., p. 169.

a Federal Reserve Bank $15 out of every $100 of its own deposits and has $85 to lend or invest. If the reserve requirement is 10 per cent, it needs to keep only $10 uninvested and $90 to lend or invest. Therefore, a change in reserve requirements changes the rules under which a bank must operate.

Since changes in reserve requirements affect at the same time and to the same extent, all member banks subject to a change in reserve requirements, they are considered to be a potent instrument. When the available reserves or liquidity of a bank are increased or decreased, it has a prompt effect on the rate of bank lending, investing and in the rate of monetary expansion provided there is no change in the banks attitude toward lending.

Selective Credit Regulation

The powers discussed so far are known as general means of regulating the flow of credit and money. In addition to these means, the Federal Reserve has special powers to regulate the credit terms on which transactions in stock markets are financed. At times it has been authorized to prescribe terms on which consumer credit and certain real estate credit could be extended. It also has been empowered to encourage lenders to restrict other types of credit voluntarily.

Selective credit instruments prescribe the terms on which lenders may make certain types of loans, regardless of the reserve position of commercial banks.

For example, if one area is developing an unhealthy use of credit and other credit is normal, the over all controls would harm other activities. So the Federal Reserve can use its powers of selective regulation on that item. This will prevent the normal areas from being harmed by regulation.

The foregoing has been a discussion of the methods and instruments used by the Federal Reserve System to regulate credit and monetary policy.

Some economist have claimed that the Federal Reserve's policies have failed in their attempt to provide our economy with the needed checks and controls as far as the money supply is concerned. These critics point to the fact that if borrowers want to borrow badly enough, they are willing to pay almost any interest rate as long as it is lower than the marginal efficiency of capital. These critics also point to the fact that if the prospects for profit using borrowed funds is not good then, then it is difficult to induce them to borrow regardless of how low the interest rates are set.

These critics fail to take into consideration, however, that these represent extreme conditions. A significant comment

was made by Blodgett in his book, Our Expanding Economy:

> By themselves any one of the methods of rediscount rate changes, open market operations, or changes in interest rates might be inadequate to check the expansion of the money supply in a period of prosperity. However, if the Board exercised all or most of its powers at any one time or successively, they should be sufficient to prevent the overexpansion of the money supply under any ordinary condition. Of course, the problem of applying the powers at the right time remains as does that of getting the Board of Governors to use its powers regardless of political or international influences.[3]

As a comment on changes in reserve requirements, it might be said that it is employed very infrequently, and to bring about relatively large changes in the reserve position of banks. This is in part due to the fact that it has acquired the reputation of being more like an ax than a "scalpel." That is, it is considered to be a powerful instrument of control. The banks in large cities complain about the way the reserve requirement system is set up. They feel that they are at a disadvantage because they must keep such a large share of their total assets

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[3]Ralph H. Blodgett, Our Expanding Economy. (New York: Rinehart and Company, 1955), p. 598.

in non-loaning form. The criticism of the system is so great that some type of reform will probably come in the next few years. They will probably be in the form of uniform requirements against demand deposits regardless of the location.[4]

As an analysis of discount rates, it is held by some authors that this policy is not a perfect one and that the conditions of American banking do not make for its perfection. They say that for it to work perfectly two conditions must exist: (1) The Reserve Bank must stand ready to lend freely at its established rate, and uses no other rationing method to regulate the volume of loans. (2) Commercial banks must have no inhibitions against borrowing from the central bank. These critics say that these conditions do not exist. They say that the central bank uses other methods and that banks have inhibitions against borrowing from the central bank. They say that there is a tradition against borrowing continuously to extend its own lending power.

Other authors point out the fact that it is wrong to dismiss changes in discount rates as ineffective and useless. They point out that: (1) Changes in discount rates are an

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[4]Lester V. Chandler. The Economics of Money and Banking. (New York: Harper and Brothers, 1949), p. 66.

effective way of announcing to both the bank and the public the direction of Federal Reserve Policy. Open market operations are not as well understood as changes in discount rates. (2) It increases the bargaining power of lenders relative to borrowing. A banker can argue, "I have to charge you more because I have to pay more for what I borrow."[5]

The argument goes on and on. It might be said that it is good to take a critical look at Federal Reserve policies and possible improvements. It might further be stated that the Federal Reserve has had a stabilizing effect on banking in America.

Moral Suasion

The Reserve banks do not merely establish discount rates and then lend passively and without complaint to all banks who wish to borrow. Instead, they often use moral suasion and other direct action to influence not only the amount of bank borrowings but also the lending and security purchasing policies of banks. At times, they use publicity, interviews, and other devices to persuade banks to borrow less and to tighten their credit policies. On occasion, as in 1947, and 1951, they encouraged banks and other lenders to follow voluntary credit

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[5] *Ibid.*, p. 167.

restraint "programs to curtail" non-essential credit.[6] On other occasions, they attempt to elicit a more liberal credit policy on the part of banks using them to liberalize their lending and to use Federal Reserve Credits if necessary.

In addition to credit functions, the Federal Reserve performs certain services of which the most important are: handling member bank reserve accounts; furnishing currency for circulation; facilitating the clearance and collection of checks and the transfer of funds; acting as fiscal agents, custodians, and depositories of the United States Government; and making available to the public the economic and financial information that serves to guide System Policy administration. The System also performs important supervisory functions that help to keep individual member banks in sound condition and to maintain the strength of the banking system as a whole.

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[6]Lester Chandler. The Economics of Money and Banking. (New York: Harper and Brothers, 1953), p. 440.

CHAPTER IV

THE EFFECTS OF THE FEDERAL RESERVE SYSTEM ON THE AMERICAN ECONOMY

The writer feels that in order to get a complete understanding of the effects of the Federal Reserve System on the American economy, an illustration should be made. This illustration should clarify some of the effects of credit and monetary changes on the American economy.

To the person who is unfamiliar with economics and fiscal policy, it might seem that the more credit and money people have the better off they are. The fact is, however, that it is not the number of dollars available but what they will buy that is important.

People usually have different tests of whether they have enough money. To the manufacturer, the test of whether he has or can borrow at a reasonable cost enough dollars to buy his raw materials, pay the wages of his employees and make other payments necessary to a profitable level of operation. The farmer, the merchant, and the banker have similar tests. To the consumer, the test is whether he has or can borrow enough money on credit charges and repayment terms that he can meet to buy what he needs.

In an economy such as our American economy, one that is dynamic and growing, enough money would have a different meaning from that of another economy. In a dynamic and growing economy it might be said that enough money and credit is that amount which will help to maintain high and steadily rising levels of production, employment and consumption, and to foster a stable value for the dollar. When credit becomes unduly scarce or excessively hard to get and costs too much, factories and stores may curtail operations and lay off employees. Smaller payrolls mean hardship for workers who curtail their purchases; merchants feel the decline in trade and reduce their orders for goods. Manufacturers may find it necessary to lay off more workers. A serious depression, unemployment, and distress may follow.

On the other hand when credit is excessively abundant and cheap, the reverse of these developments, an inflationary boom, may develop. The hazards of such a condition are vividly discussed in a booklet published by the Federal Reserve System. They are as follows:

> An increase in the volume and flow of money resulting from an increase in the supply and availability of credit, coupled with a lowering of its cost, cannot in itself add to the country's output. If consumers have or can borrow so much money that they try to buy more goods than can be

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> produced at plants running at capacity, this spending only bids up prices and makes the same amount of goods cost more. If merchants and others try to increase their stocks so as to profit by the rise in prices, they bid up prices further. Manufacturers may try to expand their plants in order to produce more. In doing so they will bid up interest rates, wages, and the prices of construction materials. In the end they raise their own costs.[1]

These are the ways in which excessive changes in credit and money can affect the American economy. This illustration although oversimplified in that it does not include all the factors that affect the level of economic activity, serves to show what will happen if, on the one hand, credit is too scarce or hard to get and too dear, or if, on the other hand, it is too plentiful or easily obtainable and too cheap. It is by influencing the flow of credit, with resulting effects on the flow of money, that the Federal Reserve influences the American economy.

Practically all the money used in the American economy reaches the people, directly or indirectly through banks. They may receive their pay in cash, but the employer who pays them will have cashed a check at the bank and may have borrowed from a bank

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[1]Board of Governors, The Federal Reserve System, _Purposes and Functions_. (Washington, D. C.: Board of Governors, 1954), p.9.

before making up his payroll. Therefore, the flow of money in the country depends mainly on the ability of banks to meet the credit and monetary requirements of industry, trade, agriculture, and all the other sectors of economic life.

The ability of banks to meet the credit and monetary needs of the people depends on the amount of reserves the banks have. This in turn is affected by Federal Reserve operations. Banks can extend credit to customers or invest money in securities only in proportion to the reserves at their disposal. The way the system of reserve works, and the fact that under it the banks can lend in the aggregate several times as much as they have in reserves, will be discussed later. What needs to be understood first is that the Federal Reserve, though influencing the availability and the cost of additional bank reserves, can influence the amount of credit the banks may extend to the public through loans and investments, and thus influence total flow of credit and money. The reserve position of banks affects directly the willingness of banks to extend credit and the cost, or rate of interest which borrowers will have to pay to obtain it. The Federal Reserve thus has the power to influence the country's credit situation and, since bank loans and investments are the main assets that serve as backing for deposits, its money supply.

The Federal Reserve is not the only factor affecting the credit and money supply. The other factors include, governmental policies in regard to expenditures, taxes, and debt, the distribution of income among different groups of the population, the bargaining strength and policies of management, labor, agriculture and other sectors of the economy, the course of foreign trade and foreign investment, and the prospects for peace or war.

Thus the Federal Reserve alone cannot assure favorable economic conditions nor can it direct whether credit shall flow into particular channels. But it can affect the general flow of credit and money as economic conditions change and thus help to counteract instability resulting from other forces. The supply of money and credit, and the incentives to use credit and money, which the Federal Reserve does influence, are indispensable factors in modern economic life.

Federal Reserve influence is exerted primarily through the credit market. Unlike the organized stock or commodity markets, the credit market has no specific place of business. As a matter of fact, modern means of communications make the country practically one national credit market in the financing of large transactions. Well-established borrowers with high credit ratings can obtain bank or other loans on much the same conditions in one city as in another, for if lendable funds are scarce and costly in

one center, the supply tends to be replenished from other centers where it is more abundant. Relatively small transactions originating from local needs and represented by loans based on close contact with local conditions are handled by the many regional credit markets. The rates of interest charged and other conditions in these local markets may vary somewhat from place to place, but they are, nonetheless, related to one another.

Contacts of these local markets with the national market, and thus with one another, are maintained in part through balances kept by local banks with city correspondents. They are also facilitated through direct credit contact between city banks and large out of town businesses; through a network of brokerage and other local contacts with the large regional and national saving institutions; through the relationships between local dealers in investment securities and the underwritings houses and stock exchange members of the financial centers; and through the mechanism of the Federal Reserve System. Funds from the local markets are likely to flow in and out of the financial centers with changes in local demand for credit.

Through this flow of funds, banks in all parts of the country, as well as other financial institutions, are in constant contact with the national market. The movement of funds between the national market and the local market is no longer disruptive

as it frequently was before the organization of the Federal Reserve System. The Reserve Banks can supply additional funds to the market if necessary or can absorb excess funds.

Federal Reserve actions affecting the credit market are directed for the most part to the functioning of banks. Such actions influence the market as a whole, however, since they affect the availability of funds to other lending institutions, their attitude toward prospective borrowers, and their appraisal of investments. The attitude of lenders toward loan and investment opportunities is sometimes referred to as the tone of the market. When bank reserve funds are more readily available, banks lend and invest more freely, as do other financial institutions; and the tone of the market is easy. When bank reserve funds are less readily available, the opposite situation prevails and the tone of the market is tight.[2]

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[2] Ibid., p. 30.

CHAPTER V

SUMMARY

As the foregoing chapters have explained, the basic powers of the Federal Reserve relate to credit and money. They are credit powers in that they directly affect the ability of commercial banks to supply funds to the credit market and indirectly influence the willingness of other lenders to supply funds. They are monetary powers in that they affect the size of the money supply, which consists in part of currency and in much larger part, demand deposits.

The Federal Reserve System was established to correct certain defects in our banking and monetary system. These defects were diagnosed as "inelastic currency" and scattered bank reserves. The system promptly cleared the way for correcting these defects.

From the beginning the Federal Reserve System has provided elasticity. The system for doing this has worked almost automatically. It has also corrected the condition known as scattered bank reserves.

Federal Reserve System was established in an era when the country's financial problem was one of scarcity of credit and money and rigid limitation on expansion. To a considerable

extent, because of a long period of international political unsettlement, involvement of the United States in two major wars, and the inflow of gold following two world-wide economic depressions, the financial problem with which the system has been concerned has been one of abundance and need of restraint.

The Federal Reserve System is a unique banking mechanism, essential to a dynamic, private enterprise economy like ours. It is especially adapted to a banking system with many independent banking units, today numbering some 15,000 of which nearly 7,000 are System member banks. Through its twelve Reserve Banks and their coordination, through the Board of Governors in Washington, the System is designed to combine private and public welfare. Experience has shown during the System's four decades of operation that reserve banking is a potent and indispensable instrument of public policy, that under conditions of peace it can facilitate economic stability and progress; and that in the event of the threat of war or war itself, it can be an invaluable aid in facilitating the financing of essential programs and in alienating resulting economic disturbances.

The Federal Reserve System is a service institution to the nation. The more than 250 directors of the twelve Reserve Banks and their twenty-four branches, the 20,000 officers and others who work in them, as well as the Board of Governors and its staff in Washington, are all serving as trustees of the nation's economy.

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