Federal reserve

Business

Prior to the Federal Reserve Act of 1913, central banking and the concept of positive credit policy aimed at protecting the public interest were essentially absent in the United States.

Since the inception of banking in this country, the banking system, which issued part of the circulating currency as well as holding deposits, had been subject to intermittent crises and ensuing waves of liquidation and depression. During these periods, the public demanded gold and currency from the banks. Such wholesale cash drains the banks were not prepared to meet. The pressure of withdrawals forced individual banks to call loans and liquidate other assets, putting deflationary pressure on businesses, individuals, and the security markets. This in turn intensified the aura of pessimism and uncertainty, leading to further currency withdrawals, and so the deflationary spiral went.(Dorfman, page 41) Therefore, the government had to invent an institution which could reserve funds and help to maintain economical position through different circumstances.

In this paper I show the aspects of Federal Reserve and its importance to national economy. The purposes of the Federal Reserve Act were: “ 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.” More specifically, it was generally agreed that the new legislation was aimed at accomplishing four major goals.(Dorfman, page55) These were: The act as passed represented not only a compromise between regionalism and centralism, but also a compromise between the philosophies of credit accommodation and of control. While the desire to mitigate financial

crises and depressions was apparent through- out, contemporary banking theory and popular feeling on the whole agreed that improved currency and reserve arrangements, coupled with " sound" individual banking practices (restriction of lending to the security of short-term, self-liquidating commercial paper), were all that were needed.

If banks accommodated their customers soundly, on the basis only of short-term, self liquidating paper, and if facilities were provided to ease the stringencies of financial crises, the proper amount of money to meet business needs would be automatically forthcoming, and no other conscious control would be needed. In the background, the gold standard provided a basic determinant of the volume of bank reserves, again a largely automatic control requiring little conscious centralized " monetary" or " credit" policy. Reflecting this philosophy, the original act paid little explicit attention to what has since become the main purpose of the Federal Reserve authorities – the establishment of a national monetary and credit policy conducive to maintenance of general economic stability. Instead, the act was mainly concerned with what are now generally termed " service" functions – pooling reserves, clearing interregional checks and currency, providing currency, and serving as fiscal agent for the government. Credit control, in so far as it was envisaged in the act, was seen largely as a problem of establishing " sound" banking practices. The act did provide for various powers, including changes in rediscount rates, open-market operations, and examination of member banks, that were aimed at promoting " sound" credit conditions.

But, on the whole, these were secondary to the basic gains expected from provision of an elastic currency and centralization of bank reserves.

Determination of the proper amount and use of currency and bank credit was felt to be provided by adherence to the gold standard plus sound commercial banking practices. With little recognition of the need for any conscious policy of credit control, only minor emphasis was given to the possible need for a unified national credit policy, and only general supervisory powers were placed in the Federal Reserve Board to control the credit policies (rediscount rates, open market operations) of the twelve Federal Reserve banks which dealt directly with the member (commercial) banks (Mullins, page 53). …