

June 16, 1959.

The Honorable Wilbur D. Mills,
Chairman,
Committee on Ways and Means,
House of Representatives,
Washington, D. C.

Dear Mr. Chairman:

In his testimony before the House Ways and Means Committee on June 11 Mr. Patman stated that the Federal Reserve Board had reported to Congress that "its present holdings of \$25 billion of bonds and other interest-bearing obligations of the United States are a great deal more than the needs for all purposes and all possible contingencies." This alleged statement is a misreading of an analysis presented in a Board staff study dealing with member bank reserve requirements and their sources. I quote the relevant passages of this study:

"It may be concluded from this discussion of the appropriate level of reserves that, to permit effectuation of appropriate monetary policies, reserve requirements of member banks do not need to be as high as they have been in recent years. A lower level of requirements would improve the earning position of banks and aid them in building up their capital positions to levels commensurate with the more rapid expansion that has occurred in their liabilities during the past 30 years. Some reduction in reserve requirements would not necessarily impair the liquidity and safety of banks' assets if banks are prudent in the use of additional funds obtained. Any substantial reduction in requirements, however, might raise questions about the adequacy of safety or liquidity in the asset structure of banks, unless offset by other additions to liquidity.

"To the extent necessary to avoid undue credit expansion, reserves released by any reduction in requirements could be

absorbed by Federal Reserve sales of securities in the market. This would in effect shift earning assets from Federal Reserve banks to member banks. The present System portfolio is adequate to permit a substantial reduction and still leave enough to provide sufficient earnings to cover necessary expenses, as well as for current purposes of policy.

"Any decrease in requirements, however, should leave the Federal Reserve with a portfolio adequate to cover possible future contingencies, such as a large inflow of gold or economies in the use of currency that might add reserves in excess of appropriate needs. In view, moreover, of the growing international liabilities of this country, the reserve base of member banks, as well as that of Federal Reserve banks, should be maintained at a level that would permit further reduction of requirements if needed to cover a future drain on our gold reserves.

"While normal growth of the economy may require some increase in the supply of money and in needs for additional reserves, there may be large potentialities for economies in the use of money, which make any projections of future needs unreliable. Reserves should be released only as needs actually arise and not in anticipation of possible needs.

"Any substantial release of reserves within a short period of time can have disturbing effects on credit markets and on the economic system generally. Although the amount of any such release can be offset by absorption of the same amount through Federal Reserve sales of securities, the initial uses that might be made of the actual reserves released cannot be controlled. Increased leverage for credit expansion permitted by lower reserve requirements may also present problems of adjustment.

"For these various reasons, any reductions in reserve requirements have to be made in relatively small amounts over extended periods of time. They should be made only at times when money market and credit conditions are such that undue credit expansion in some lines would not occur

before it could be brought under control. The Federal Reserve should have no mandate or commitment to reduce requirements to some specific level within a definite period of time. Legislative authority should be sufficiently flexible that changes can be made in a manner, in amounts, and at times that do not conflict with the needs of monetary policy."

The above conclusions and observations relate to reserve requirement levels that might be established in the future. Given the present reserve requirement levels, the existing Federal Reserve portfolio of Government securities is essential to the System's operations. For instance, if \$15 billion of these obligations were cancelled immediately as Congressman Patman suggests, there would have to be \$15 billion extracted from the liability side of the Federal Reserve financial statement. This would have to be balanced by \$15 billion taken out of the reserve balances of member banks or \$15 billion taken out of Federal Reserve notes in circulation.

I may say that the statement above quoted from the staff study was preceded by a detailed analysis of the factors that may influence in the future the availability of and the needs for bank reserves. Its principal conclusions were that reserve requirements should not be substantially reduced in the near future and that the System should maintain an adequate portfolio of securities which might be sold to offset the effects of any substantial gold inflow or return flow of currency from circulation.

I trust this adequately covers the subject for your records.

Sincerely yours,

Wm. McC. Martin, Jr.

cc: Mr. Thomas
Mr. Shay
Mr. Martin

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