FEDERAL RESERVE BULLETIN

VOL. 23 JANUARY 1937 No. 1

REVIEW OF THE MONTH

New Treasury gold policy

On December 21 the Secretary of the Treasury announced that the Treasury "proposes, whenever it is deemed advisable and in the public interest to do so, to take appropriate action with respect to net additional acquisitions or releases of gold by the Treasury Department. This will be accomplished by the sale of additional public-debt obligations, the proceeds of which will be used for the purchase of gold, and by the purchase or redemption of outstanding obligations in the case of movements in the reverse direction."

The operations under this policy permit neutralizing the effect on member bank reserves of future gold acquisitions or sales of such gold. Effects on reserves of additions to the gold supply, either from imports or from new production, will be offset by the sale to the public of an equivalent amount of United States Government obligations and by the setting aside of the purchased gold in an inactive account in the Treasury. In this way the gold will be kept out of the country's credit base. An outward movement of gold acquired through sale of bills will be similarly offset by the purchase or redemption of United States obligations in the market, thus restoring to it the funds lost through the export of gold. To this extent, therefore, the volume of member bank reserves will neither increase nor decrease as the result of changes in the supply of gold.

The announcement by the Secretary of the Treasury states that the action was taken after conferring with the Board of Governors of the Federal Reserve System. The problem of dealing with the volume of excess reserves which is now in existence will not be affected by the new policy.

Continued growth of member bank reserves

Reserve balances of member banks, which have been increasing rapidly in recent years, reached a new high level of $6,800,000,000 in the early part of December, largely as a result of continued gold imports. Of this amount $4,600,000,000 constituted required reserves and $2,200,000,000 excess reserves. From the effective date of the 50 percent increase in reserve requirements last August to the beginning of December total reserves of member banks increased by $580,000,000. Of this increase $160,000,000 has been absorbed by an increase in required reserves resulting from a growth in the member banks' deposit liabilities, and $420,000,000 has been added to excess reserves of member banks throughout the country.

In the three weeks from December 2 to December 23 excess reserves declined by about $320,000,000, as a result of increases in money in circulation preceding Christmas and in balances of the Treasury at the Reserve banks, built up by quarterly income tax receipts and the sale for cash of new Treasury securities. This reduction in reserves, however, is temporary, since the return flow of currency from circulation after the Christmas holidays and disbursements by the Treasury out of its balances with the Reserve banks may be expected to build up member bank reserves in January to a level at least as high as that at the beginning of December. The new Treasury policy of offsetting the effect of gold movements on reserves will prevent any further increase that might result from additional gold imports and purchases of domestic gold.

Growth of member bank reserves in the

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

January 1937

past three years has been due to gold imports of $4,000,000,000, to gold acquired from domestic sources in the amount of $500,000,000, and to $800,000,000 of silver purchased by the Treasury against which silver certificates were issued. While gold imports have been the principal factor in the growth of the total volume of member bank reserves, other factors have widely distributed these reserves among the different groups of member banks and the different sections of the country. This distribution has been effected by the complex of industrial, commercial, financial, and governmental transactions which involve the continuous shifting of funds among regions and among banks.

Factors affecting volume and distribution of excess reserves

Gold imported into this country is sold to the Treasury and Treasury checks are drawn in payment for the gold or for the foreign exchange used to purchase it. These checks are drawn upon the Treasury's balances at the Federal Reserve banks, and become available to member banks, which deposit them at the Reserve banks and in exchange receive credits to their reserve accounts. Reserve balances of member banks receiving Treasury checks are thereby increased. In the past the Treasury did not offset this increase but replenished its balances with the Reserve banks by giving the Reserve banks an equivalent credit in the gold-certificate account. Under the newly adopted Treasury policy the Treasury will segregate the gold and will replenish its balances at the Reserve banks by the sale of Treasury bills in the market. This operation will diminish member bank reserves, thus offsetting the previous increase.

Since most of the foreign exchange transactions take place in New York, the effect of gold imports on member bank reserves has been as a rule immediately reflected in additions to the reserves of New York City banks, but in time these reserves have become widely distributed among banks elsewhere. In some cases this transfer to other parts of the country may occur immediately after or even antedate the completion of the gold transaction. The foreign exchange used to obtain the gold may be obtained from an exporter, a foreigner purchasing securities in this country, or someone transferring a balance to this country, and this seller of exchange may deposit the funds or use them to make payments elsewhere than in New York. Thus reserves may be transferred from a New York City bank to a bank elsewhere before the gold is sold to the Treasury.

Subsequent to the importation of gold the continuous flow of funds in connection with a variety of payments leads to a broad distribution of the additional reserves thus acquired among different banks and regions. It is not possible to measure quantitatively the complex elements that make up this flow of payments, but several of the more important movements may be enumerated. Improvement in agricultural conditions since 1933 and the increase in farm income have carried funds to agricultural regions in payment for their crops sold at higher prices. Likewise industrial expansion in various sections of the country has resulted in a substantial shifting of funds to such sections. Perhaps the most important factor in the geographical distribution of surplus funds of banks since 1933, however, has been the expenditure by the Treasury of funds raised by the sale of Government obligations to banks.

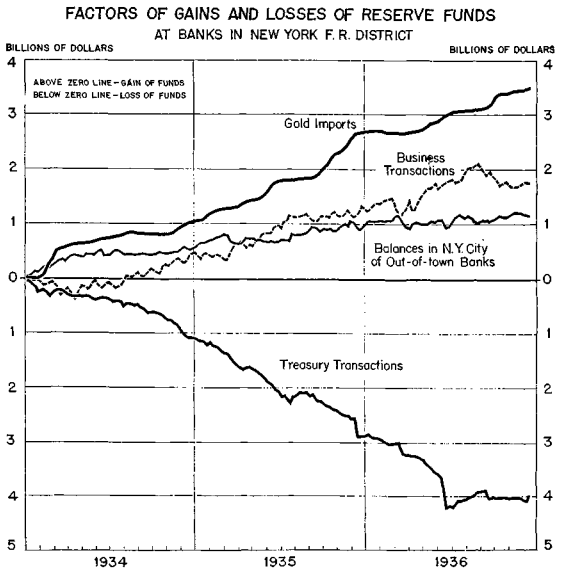
Funds spent by the Treasury are not necessarily raised in the locality in which they are spent and do not necessarily remain in the particular section in which payments are made. The bulk of them may be transferred from one locality to another for the purpose of investment or in payment for goods and services; and with each transfer there is a shift of member bank reserves through the clearing system. City banks, especially those in New York City, have until recently bought relatively more Government securities than the so-called country banks, but expenditure by the Government throughout the country of

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

January 1937

funds obtained from city banks has tended to reduce the excess reserves of city banks and to distribute them widely among country banks in different parts of the country.

Country banks thus acquiring excess funds



Weekly figures of net gains and losses cumulative from January 1, 1934, through December 16, 1936.

have kept a portion as excess reserves with Federal Reserve banks, have invested a portion, and have placed a substantial amount on deposit with correspondent banks in financial centers. Balances carried by country banks with city correspondents are now more than twice as large as they were at any time prior to 1934. City banks have, therefore, continued to hold a large part of legal excess reserves, but a portion of these reserves in effect belongs to country banks which may withdraw them on demand.

Figures have been compiled by the Federal Reserve Bank of New York measuring important elements in the movement of funds into and out of the New York Federal Reserve district, comprised mostly of transfers into and out of New York City. These figures illustrate the way in which reserves of banks in New York are affected by gold imports and the shifts of funds between them and banks in other parts of the country. A summary of the more important of these figures is given in the chart, which shows cumulative movements since the beginning of 1934 when gold imports, excess reserves, and bankers' balances all began to increase rapidly.

The chart shows that during the past three years New York banks have gained reserves through gold imports, and that there has also been a net gain of funds by the New York district from other parts of the country arising from an increase in balances held in New York City for outside banks and from other transactions growing largely out of ordinary commercial and financial operations. During the same period the Treasury has made large withdrawals of funds from the New York district, representing the excess of funds raised in the district through the sale of Government securities and through tax receipts over Government disbursements in the district. These funds have been spent by the Government in other parts of the country, thus shifting reserve funds from New York banks to outside banks. Upon receipt of these funds the banks outside of New York, however, have in part redeposited them in the form of bankers' balances with New York City banks. As a consequence of these various movements total reserves and excess reserves of New York banks and total reserves, excess reserves, and New York balances of outside banks have all shown a considerable growth.

Distribution of reserves among classes of member banks

The preceding paragraphs have described how gold imports in recent years have increased the aggregate volume of excess reserves, and how Government borrowing and spending and other ordinary business and financial transactions have distributed the increased reserves among the various classes of member banks. As shown in the following table and also in the chart, all classes of member banks in the latter half of November had much larger excess reserves than in January

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

January 1937

1934, and, notwithstanding the recent increase in reserve requirements, the ratio of excess to required reserves for member banks in the aggregate was somewhat larger than at the beginning of 1934.

DISTRIBUTION OF EXCESS RESERVES, BY CLASSES OF BANKS

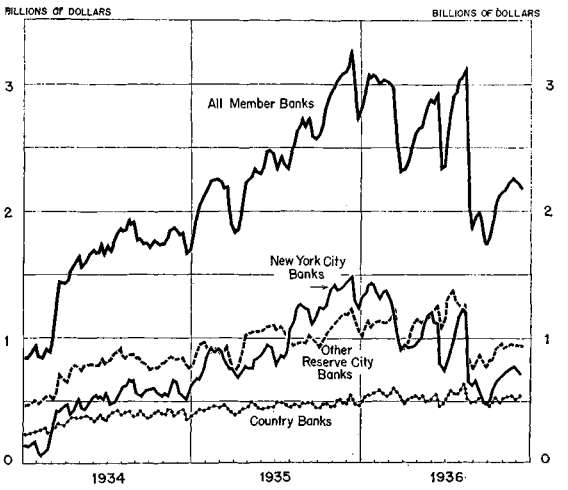
[Averages of daily figures]

	Amount of excess reserves (in millions of dollars)			Percent of excess to required reserves		
	Jan. 1934	Aug. 1-15, 1936	Nov. 16-30, 1936	Jan. 1934	Aug. 1-15, 1936	Nov. 16-30, 1936
Central reserve city banks:						
New York	147	1,226	767	20	96	39
Chicago	171	290	225	110	103	52
Reserve city banks	305	970	729	52	104	50
Country banks	242	619	518	64	131	71
All member banks	866	3,105	2,240	46	105	49

Aggregate reserve balances of member banks in the latter part of November were slightly less than 50 percent in excess of requirements. Banks in reserve cities held excess reserves of 50 percent, while the so-called country banks held reserves of 70 percent above requirements. Central reserve city banks in New York City, with reserves of about 40 percent above requirements, had the smallest percentage of excess reserves of any class of banks.

Excess reserves of the various classes of banks are smaller than they were before the increase in requirements last August, but, owing to the subsequent growth in total reserves, they are substantially larger than immediately after the increase went into effect. All classes of member banks have shared in this increase in reserves, but the gains have been unequal, and the relative distribution of excess reserves among the various classes of banks has been considerably altered. In the case of New York City banks required reserves increased by $675,000,000 between the first half of August and the latter part of November, as a result of the Board's action and of further expansion in deposits. Since the reserve funds of these banks increased by only $215,000,000, their excess reserves declined by $460,000,000. Reserve city banks, at which required reserves have increased by $530,000,000, showed a loss of but $240,000,000 in excess reserves. At country banks, notwithstanding increased requirements of nearly $260,000,000, excess reserves declined by only $100,000,000 from an unusually high level in the first half of August, and are now at about the same level as in the first half of 1936.

EXCESS RESERVES OF MEMBER BANKS



Averages of daily figures for weeks ending Friday; figures for country banks and for all member banks are estimated.

Bankers' balances

Owing to the large volume of balances that banks outside of New York City carry with correspondent banks, the effective, as contrasted with the technical, reserve position of these banks is considerably understated when their balances with Federal Reserve banks alone are considered. Banks outside of New York require balances with correspondents to serve as secondary reserves and for clearing purposes, but the volume of such balances at the present time is much larger than normal requirements. New York City banks have continued to hold only small working balances with correspondents. On June 30, 1936, all member banks held demand balances with

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

January 1937

other domestic banks of $3,800,000,000, whereas from 1922 to 1929 they held an average of $1,900,000,000, which may be considered as a more nearly normal amount of working balances.

Of the total bankers' balances on June 30 about $1,700,000,000 belonged to country member banks, compared with $900,000,000 held by them at the end of 1929. Last July and August, following announcement of the increase in reserve requirements and about the time of its effective date, between $100,000,000 and $200,000,000 of bankers' balances were withdrawn from New York City banks, and there were also some withdrawals from banks in other cities. Since that time, however, country banks have again built up their balances with correspondents, and it is estimated that in November they were fully $200,000,000 larger than last June. When balances with correspondent banks, as well as excess reserves, are considered, it appears that total unutilized funds owned by country banks at present are larger than last summer, before reserve requirements were increased.

Reserve position of individual banks

It has been pointed out that in November each class of member banks taken as a group had aggregate reserve balances considerably in excess of requirements. A survey of the reserve position of member banks shows that this was true also of the majority of individual members. The results of this survey have been tabulated so as to show the number of banks that have reserves 16⅔ percent above requirements, or sufficient to meet an increase of one-half of the Board's authority to raise reserve requirements; banks that have reserves between 16⅔ and 33⅓ percent above requirements, and banks that have reserves 33⅓ percent or more above requirements, which would be sufficient to meet the maximum authorized increase in requirements. Out of the total of 6,400 member banks in the first half of November, nearly 3,800, or 59 percent, had reserves that were 33⅓ percent or more in excess of current requirements. About 60 percent of all country banks and 47 percent of all central reserve and reserve city banks were in this position. The results of the survey are summarized in the following table:

NUMBER OF MEMBER BANKS DISTRIBUTED ACCORDING TO PERCENTAGE OF EXCESS RESERVES

[Based on daily averages for first half of November 1936]

Ratio of excess to required reserves	All member banks	Central reserve city banks		Reserve city banks	Country banks
		New York	Chicago		
Less than 16⅔ percent	1,445	14	4	110	1,317
16⅔ percent–33⅓ percent	1,171	8	1	71	1,091
33⅓ percent and over	3,772	15	12	155	3,590
Total number of member banks	6,388	37	17	336	5,998

The 2,600 banks which in the first half of November had excess reserves amounting to less than 33⅓ percent of required reserves were short of this amount by a total of $350,000,000, of which $120,000,000 was at central reserve city banks in New York and $230,000,000 at other banks. With comparatively few exceptions banks outside of New York City were in a position to cover the difference by using not more than half of their balances with correspondents, which have been approximately twice as large as was customary prior to 1934. New York City banks, however, hold only small working balances with other banks. The principal New York banks showing excess reserves of less than a third of required reserves hold substantial amounts of liquid assets, such as Treasury bills and notes, bankers' acceptances, and brokers' loans, which can be readily sold or called and thus shifted to other banks that have excess reserves.

Effects of increase in requirements

An increase in reserve requirements at a time when member banks hold sufficient excess reserves to meet the increase results in making unavailable as a basis of credit expansion a portion of member bank funds for which these banks

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

January 1937

are not finding a profitable outlet. An increase at such a time has no immediate effect upon the supply of credit in the money market, but merely limits a possible future growth in this supply.

The balance sheet of the Federal Reserve banks is in no way changed by an increase in reserve requirements of member banks, except to the extent that member banks may borrow to meet the increase. So long as member banks have excess reserves out of which to meet the increase, it does not affect the total amount of deposits at the Reserve banks, but merely converts a portion of the deposits already held from reserves held by member banks with the Reserve banks in excess of requirements to required reserves. It has no effect whatever on the volume of funds available to the Reserve banks for investment.

Source of Reserve bank lending power

From the nature of the functions of the Federal Reserve banks it is clear that it is not a correct description of their operations to say that they invest funds deposited with them by member banks. The lending power of the Reserve banks is derived from the authority they have to issue Federal Reserve notes and to create deposits on the basis of a 40 or a 35 percent reserve, respectively, to be held against notes and against deposits. When a Reserve bank purchases in the market a United States Government obligation and pays for it, directly or indirectly, with a deposit credit on its books, it adds to the reserve deposit of some member bank. It is for this reason that the Reserve banks purchase United States Government securities when they wish to ease the credit situation by placing additional funds at the disposal of member banks.

Mechanically the process is as follows: when a Reserve bank purchases a Government obligation, it pays for it by a check drawn on itself. The seller of the obligation deposits this check at his bank, and the bank in turn deposits it at the Federal Reserve Bank where it is credited to the depositing bank's account. Similarly when a Reserve bank discounts paper for a member bank or makes an advance to it, the member bank's reserve account is credited with the amount involved. In both cases, therefore, member bank deposits at the Federal Reserve banks are increased.

Limits of possible expansion by the Reserve banks are not related to the legal distinction, as between required and excess reserves, of member bank deposits that they hold, but are set by the amount of cash reserves of the Reserve banks themselves. The extent to which the lending power of the Federal Reserve banks is put to use, however, is not determined by the theoretical possibilities of expansion on the basis of available reserves or by the possible earnings from such expansion, but solely by a consideration of the amount of reserve funds required for the accommodation of commerce and business and the maintenance of sound credit conditions.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis