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FEDERAL RESERVE BANK
OF NEW YORK

July 30, 1942

Dear Marriner:

Today has been a day almost completely taken up with meetings so that I have not had much time to work on the memorandum which you asked me to send to you tonight. However, after talking with John Williams I have put down my views on the immediate question of excess reserves, reserve requirements and the New York money market. It is in no sense a complete job but I hope it will be of some use to you.

Yours faithfully,

Allan Sproul

Hon. Marriner S. Eccles, Chairman,
Federal Open Market Committee,
c/o Board of Governors of the
Federal Reserve System,
Washington, D. C.

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From A. Sproul

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COMMENTS ON EXCESS RESERVES AND THE NEW YORK MONEY MARKET

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Since March 1942 excess reserves of New York City banks have declined from nearly $1 billion to $250 million. There has been no disturbance in the market during this period and no failure of the banks to support the Treasury's financing program.

It is true, however, that the principal cause of the decline in excess reserves at New York has been the net loss of funds to the market on Treasury account. The Treasury has taken more funds out of the New York market through borrowing and taxation than it has put in through Treasury expenditures of various kinds, even though the latter are now running at the rate of about $250 million a week.

It might be argued, therefore, that at some point the decline in excess reserves in New York will represent a danger to the Treasury's financing program, in that purchases of new issues by New York City banks will have to be curtailed. This would be a danger, however, only if the decline in purchases by New York City banks was not offset by an increase in purchases by the banks outside New York City. One of the objectives of fiscal and monetary policy has been and still should be to tap the funds which continue in excess supply in the rest of the country. So long as reserve funds are pumped into the New York market, and subsequently drained off to the rest of the country, this problem will remain unsolved.

It is this situation which gives point to our recommendation that the System posted buying rate for Treasury bills be increased to 1/2 of 1% and that other short term rates be permitted to firm up in relation to this buying rate. Our experience with the increase in short rates which has already taken place confirms the commonsense judgment that a somewhat higher rate would further increase the non-bank market, and, especially, the non-New York bank market for short term government securities. The second question to be considered is the method by which reserve funds are to be put into the New York market to the extent that this is deemed necessary in support of the Treasury's financing program. Our view is that all three of the available methods will have to be used, open market operations, rediscounts,

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and reducing reserve requirements, but that they should be used in such a way as to indicate that we are not planning to rely mainly upon the latter method. We would postpone reducing reserve requirements, even in New York, until there is less likelihood that it would be interpreted as an indication that this is to be the chief method of providing reserves. In the existing circumstances, this will mean the continuance of open market operations to prevent any possibility of stringency here while present financing methods are being followed and present short term rates are being maintained. This is preferable to a reduction in reserve requirements because of its greater flexibility, as well as because of avoidance of the implications which a reduction in reserve requirements now would carry with it.

During the period of the August Treasury financing, open market purchases in New York will probably have to be fairly heavy. The type of financing which is in prospect is the kind which affects the reserves of the New York City banks most substantially. A large proportion of the $2\frac{1}{2}\%$ registered bonds of 1962-67 will probably be taken by insurance companies in this district. This will mean a transfer of deposits first to the Treasury, and [redacted] subsequently, on Treasury call, to banks in other parts of the country. If the second step in the financing program is an offering of certificates of indebtedness, a substantial part of the offering is likely to be taken in New York. This amount will be reduced, first, if the certificate is for one year and the coupon, therefore, more attractive to banks outside New York, and, second, if we do not unnecessarily put funds into the New York market.

Our present estimate is that we may have to purchase from $100 to $150 million of government securities drring the next two weeks (See note below) if we are to maintain about the present level of excess reserves.* We think that this will give all the protection necessary to the government's financing and that it is preferable to continue to provide reserve funds by this method rather than by reducing reserve requirements at this stage of development of the Treasury's financing program and related credit policies.

Note: Mr Sproul explained subsequently in telephone talk with Chairman Eccles that this meant $100 to $150 million per week.

*We do not subscribe to the idea that we may have already reached a minimum in excess reserves, such as $200 or $250 million for New York, and $2 billion for the country. What we know, thus far, is that excess reserves have greatly declined with

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very little disturbance. How much farther they can be reduced we can only find out by trying. We think it is particularly desirable to make this trial and eventually to get the banks to borrow. It is not the amount of borrowing but the fact of borrowing that would count, because our problem is that of dispelling the false idea that safety requires some amount of excess reserves. If the banks were adjusting their individual positions by borrowing, the idea of a safety point in excess reserves would quickly be dispelled.

July 30, 1942.