

FEDERAL RESERVE BANK
OF NEW YORK

December 10, 1942.

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

Dear Chairman Eccles:

Enclosed is a memorandum of views on Credit Policy and Treasury Financing which I have prepared in anticipation of the meeting of the Federal Open Market Committee, to be held on Monday, December 14th. I am sending a copy of this memorandum to you, and to the other members of the Committee, so that you may have an opportunity to read it before the meeting and in the hope that it may facilitate discussion of our problems at the meeting.

Yours faithfully,



Allan Sproul,
Vice Chairman, Federal Open
Market Committee.



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CREDIT POLICY AND TREASURY FINANCING.

It is essential that during the period between the present Victory Loan campaign and the next major Treasury financing--now scheduled for February 1943--there be a further determination of policy with respect to member bank reserves and Treasury borrowing methods. After a year of active participation in the war, and a year of trial of fiscal and credit policy under war conditions, the Treasury and the Federal Reserve System should be able to plot a general course for 1943.

Member Bank Reserves.

Two main problems present themselves with respect to the immediate question of member bank reserves:

1. Is there some minimum volume of excess reserves which must be maintained to help secure the success of Treasury financing during the coming year, and have we reached that minimum at \$2 1/2 billion of excess reserves for the country?
2. How are the banks to be supplied with the additional reserve funds they will need during 1943 so that they may do their part in financing the deficit?

Thus far we have been steering a course somewhere between the Treasury's desire for a commitment as to the maintenance of excess reserves at a fairly high figure, and our desire to avoid such a commitment and to do the job with the smallest possible volume of excess reserves. Since the middle of this year, however, we have in fact maintained excess reserves of all member banks between \$2 billion and \$2 1/2 billion, so that we have given the Treasury about what it wanted, and what appeared to be required in view of the financing methods used. (Large offerings for immediate subscription without prior preparation or an organized campaign to sell to others than banks.)

This has placed the System in a somewhat contradictory position with respect to its own banking and credit policies. Our program has been one of urging all banks to invest their funds in Government securities to the fullest possible extent, and we have made it profitable and practically riskless for them to do so. Such a program is compatible with the idea that the required ratio of excess reserves to bank buying of Government securities is a gradually diminishing one. It will not fit very long nor very well with a program of maintaining a constant high level of excess reserves. (Our effort to maintain excess reserves at a large fixed amount has already placed us in competition with the banks for short-term securities, thus running counter to our policy of urging the banks to keep fully invested.) If we are to adopt the Treasury views on excess reserves, we should try to make our policy more nearly conform to these views.

It is only recently that we have had an explanation of these Treasury views. It seems to be that the provision of reserve funds (open market operations) should not wait for pressure to be expressed in the market, but should be based upon consideration of prospective reserve needs of banks. It is not enough to rely upon open market operations (and borrowing ?) automatically supplying the banks with such reserves as they need, when financing of the present magnitude is contemplated, because the expression of these needs in the market may not come until the financing is under way, and market pressure during a financing period, even though taken care of as quickly as possible by the Federal Reserve System, would have an unfavorable effect upon subscriptions. There should, therefore, be an

advance determination of the probable amount of reserves that the banks will need to make the financing a success, and the banks should be supplied with these reserves prior to the offering of the issue.

This reasoning may be questioned on its fundamental assumption that a bank must have excess reserves before it will be able and willing to subscribe to new issues of Government securities at existing rates of interest, and that some specific amount of excess reserves can be determined for all banks which will make each financing a success. This conception denies one of the chief reasons for the existence of a central banking system, which is to give assurance to its member banks that in time of expanding credit needs for approved purposes, their reserve positions can and will be maintained without the pressure of higher interest rates. It is a reversion to the idea that each individual bank can and should act as its own central bank by carrying its own excess reserves. It draws heavily upon the abnormal experience of the past decade and it requires that some of the abnormalities of that period continue. It is instructive, perhaps, that no other country finds it necessary to maintain the equivalent of our large volume of excess reserves in order to secure the success of its war financing and without submitting to rising rates of interest.

So long as the method of financing which had developed during the lush period of excess reserves was being used (one or two day offerings for quick subscription and allotment), we did face the danger of declining excess reserves colliding with increasingly large Government security offerings with unfortunate results. Now that transition to the periodic drive method is taking place, however, the case for doing the job with the minimum amount of excess reserves is greatly strengthened. If the shrinkage in excess reserves is not so abrupt as to cause disturbances in the market, and if cushioned by open market operations, it could probably proceed considerably further without materially affecting interest rates or the response to new issues of Government securities.

Such a program would contribute not only to our primary objective of selling the maximum amount of Government securities outside the banking system; it also would support the only slightly less important objective of spreading the load within the banking system. So long as a large volume of excess reserves is maintained, with no possibility of control of the location of these reserves, this load will be spread most unevenly. The New York City banks, for example, will tend to use all of the reserve funds which are supplied to them, while excess reserves pile up beyond any need and without use in thousands of banks in other parts of the country.

Now that we are developing a selling program for our Government security offerings adequate to the size of the offerings, a better method than the indiscriminate maintenance of some fixed volume of excess reserves is becoming available to assure adequate banking support—by all banks—of the Treasury's financing. It is a compound of two elements:

1. Continued assurance from the central banking system that adequate reserves will be provided at all times;
2. Further education of all commercial banks, or pressure upon them, to do their share in the program with a diminishing volume of excess reserves. (I think it can be demonstrated that over a period of months the volume of Treasury securities absorbed by the banks has been a steadily increasing proportion of the amount of excess reserves held by the banks.)

The first step is to get the banks, generally, to abandon the continuous holding of substantial amounts of excess reserves and to become more fully invested, even though they may fear that a considerable part of the current increase in their deposits is only temporary. As the banks learn that they are incurring no great risk in adopting a policy of keeping fully invested, the next step is to convince them that by active use of War Loan deposit accounts they can safely subscribe for new securities in amounts considerably greater than their excess reserves at a given time. The final step is to break the barrier against bank borrowing from the Reserve Banks so that a bank which has subscribed for Government securities in excess of its surplus funds, through use of the War Loan deposit procedure, will not be under pressure even though the Treasury deposit is withdrawn before the bank's deposit position is restored in other ways.

These things are harder to do than maintaining a large volume of excess reserves. They will pay dividends, however, in keeping up the pressure for sales to non-bank investors, in bringing home to all of the banks of the country their individual responsibility for the success of the Treasury's financing program, and of permitting the Federal Reserve System to follow a credit policy which will be both effective during the war and appropriate to the conditions which may be expected in the post-war years. These things can be done by a concerted effort on the part of the Federal Reserve System, the Victory Fund Committees, the American Bankers Association, and the various State bankers associations. We should now determine what is the approximate share of each Treasury issue to be taken by the banks in each Federal Reserve District; we should indicate to the banks alternative methods of calculating what their individual subscriptions ordinarily should be; and we should make sure that they understand that they can do their part without undue risk.

If this program, which envisages a further gradual decline in the volume of excess reserves, is accepted, we shall still have to supply a very large amount of reserve funds to the banks of the country. The Board's recent estimates indicate that, if the banks continue to take approximately 60 per cent of the increase in the National debt as in recent months, bank holdings of Government securities will probably increase from about \$40 billion on December 31, 1942, to something over \$70 billion a year later, and that, largely as a consequence of this increase in their investments, their deposits will rise from \$72 billion to \$107 billion. The increase in the amount of currency outstanding during the year is estimated at \$4 billion. An increase of \$8.3 billion in reserve funds is estimated to be necessary during 1943 to support these changes, even if all existing reserves were absorbed during the year. These estimates are probably conservative, for, although it is to be hoped that the banks will not have to take as much as 60 per cent of the increase in the National debt, the actual increase in the debt may be greater than the \$65 billion estimated, if war expenditures reach the rate of \$100 billion now discussed, and furthermore the increase in currency outstanding may be more than \$4 billion.

How are the banks to be supplied with these additional reserve funds? In an earlier memorandum (Excess reserves, Reserve Requirements, Credit Policy and Treasury Financing - June 1942) it was suggested that the answer is a combination of lowered reserve requirements, open market operations, and bank borrowing. Reserve requirements have already been lowered at central reserve cities, large open market operations have been undertaken, and the way has been prepared for member bank borrowing through the establishment of differential discount rates on advances secured by short-term U. S. Government obligations. All of these methods can still be used.

It is not practicable at present, however, further to reduce reserve requirements. The requirement in central reserve cities, where the pressure is still greatest, is probably low enough. The basis for reduction in other classifications does not exist so long as these banks still have over \$2 billion of excess reserves which they are not using even under present favorable conditions. When that situation has been corrected, some further adjustment of reserve requirements, which would be appropriate to the war period and have due regard for the difficulties we shall face in the post-war period, could be made. The following figures are again suggested as limits for reductions to be made in reserve requirements during the war.

Percentages of Reserves to be Maintained against -

	Central Reserve City Banks	Reserve City Banks	Country Banks
Demand Deposits	20	16	12
Time Deposits	5	5	5

The approximate amount of reserves which would be released by reductions to these levels would be as follows (based on deposits in September, 1942, the last published figures):

	(Millions of Dollars)
Central Reserve City Banks	\$ 10
Reserve City Banks	710
Country Banks	250

Open market operations should continue, meanwhile, to be the principal method used in making additional reserve funds available to the banks. In view of the present distribution of excess reserves, this is a more selective process of providing reserve funds than a reduction in reserve requirements, and the dosage can be more easily regulated.

The open market method of providing reserve funds has its problems, however, particularly when combined with a policy of maintaining substantial excess reserves and a "pattern of rates." As the amounts involved have increased, the difficulties of our purchase program have increased; it is no longer easy at all times to buy the amounts of short-term Government securities required, and at the same time to maintain a substantial fixed volume of excess reserves. The banks are being urged to keep fully invested, and are provided with additional funds in excess of their needs to enable them to subscribe to and to hold new issues. This naturally conflicts with their use as a source of supply for System account purchases. And the selling of non-bank holders tends, increasingly, to take the form of sales of premium bonds, thus forcing us to validate a profit accrued over a long period of declining interest rates.

This situation has led to suggestions that our purchases, for the purpose of putting reserve funds into the market, should be made direct from the Treasury. This would enable us to buy short-term securities, at par, in whatever amounts are required, and might also enable us to accelerate purchases before each Treasury financing (to build up a reservoir of reserve funds) and to feed into the market the amounts the market would absorb after the financing is completed.

Judgment on this question, it seems to me, must be based largely on the importance which we ascribe to maintaining the thin line between present financing methods and direct financing of the Treasury by the central bank. We should not be swayed by questions of dealer profits (small) involved in some of the present hokus

present program. It is primarily a question of public reaction, which I think would be bad and might be disastrous. Even in England, where there was better precedent for the practice, central bank purchases of Government securities direct from the Treasury have been limited and confined to special circumstances. To preserve the form of ordinary borrowing, the fairly transparent Treasury deposit mechanism has been created. Another question, directly related to this primary question, is the possible end of the road of direct purchases, except such as those which have already been made to meet temporary situations. If the Federal Reserve System were to accumulate a large portfolio of Government securities purchased direct from the Treasury, ammunition would be provided for those who have long advocated that we finance the Government without interest. Once we cross the present thin line, I should be afraid that we might have to go down that road.

Another means of helping to relieve the situation, which is more nearly in accord with our established practice, does exist, however, and would be useful, particularly if the policy of gradually declining excess reserves is adopted. First, there would be a substantial increase in offerings of bills (and of certificates) paralleling the need for additional reserve funds, so that we could supply these funds more largely through purchases of very short paper. Second, the Treasury could continue the temporary use of the special certificate of indebtedness, to anticipate the receipt of funds from security offerings, as it did prior to the December financing. This would have the effect of putting funds into the market before a financing and taking them out after the financing by an almost automatic process. Such an operation would not disturb the market as would Federal Reserve purchases from the Treasury and subsequent attempts to sell to the market, and it would conform to the pledges given when the authority to purchase Government securities direct from the Treasury was granted by the Congress.

Finally, borrowing by the banks should not be dismissed as a supplement to other means of providing reserve funds. It is not suggested that banks would subscribe for the necessary volume of Treasury securities at present rates if they had to obtain all or a substantial part of the necessary reserve funds through borrowing. It is suggested that borrowing is a semi-automatic method of providing reserve funds for individual banks exactly when and where the funds are needed, and that a substantial amount of reserve funds could steadily be made available to the banks through this window, even though individual bank borrowing was temporary in character. (It is recognized, of course, that banks which hold Treasury bills will probably "borrow" at the bill window through use of the repurchase agreement.) If it were arranged to have some of the leading banks of the country set the fashion so that no discredit would adhere to borrowing, it is believed that the banks of the country would readily resume the habit.

Treasury Borrowing Methods.

The apparent success of the Victory Loan campaign, which is now in progress should establish this method of borrowing larger amounts less frequently than in the past, as standard practice. Our experience thus far in the present campaign raises certain questions which should be discussed with the Treasury before another campaign is undertaken.

1. The question of organization is still important. Organization in the various districts has been, to a considerable extent, a matter of improvisation as we went along. This will be tightened up before the next drive. Effective organization at the Treasury is also to be accomplished, assuming that the Secretary of the Treasury is still

Treasury and the Under Secretary cannot give their continuing attention to this one phase of their work. This seems to be a sore spot, but more effective National direction of the promotion and sale of Government securities should still be recommended.

2. An allied problem is the expense of the sales and promotional campaign necessary to the success of the drive method. The Treasury appears to have been reluctant to request appropriations from Congress to pay some of the costs of selling its securities, and reluctant also to engage in those negotiations concerning advertising and other promotional methods which a complete sales program will require. While it is believed that the services of salesmen can be retained on a voluntary basis, except for out-of-pocket expenses, it is not believed that the Treasury can or should continue to depend entirely on contributions from banks and corporations for its sales promotion work. Neither should it depend on the Federal Reserve Banks. This is a legitimate part of the cost of selling a very large amount of Government securities. The funds should be provided by the Treasury, and the use of the funds should be directed by the Treasury working through the Federal Reserve Banks and the Victory Fund Committees.

3. The length of time between Victory Loan campaigns will determine to some extent the continued effectiveness of the volunteer sales organization and the continued response of investors. It is suggested that bi-monthly drives are too frequent for the best results and that, specifically, every attempt should be made to raise enough money in the present drive so that the next Victory Loan campaign can be postponed until April 1943. If necessary, this suggestion would include extending the present drive into the first week of January in order to take advantage of the existing momentum of the selling group and of the January reinvestment demand. If this is to be done, it should be decided promptly so that plans may be made for the extended drive. A study to show where and how the Treasury might finance its requirements until April 1943, in the absence of another Victory Loan campaign prior to that month, should be made immediately.

4. Separation of bank offerings from non-bank offerings should also be considered. The bank offerings in the December drive have tended to get lost in the crowd, and the Victory Fund Committees in any case have little to do with sales to banks. Offerings to banks can be used to fill in the periods between Victory Loan campaigns and the drives could then be directed solely at non-bank investors. There is an advantage also in making rather frequent offerings of securities to the banks in not too large amounts. It fits in well with the idea of a gradually diminishing volume of excess reserves and of educating the banks generally to undertake to keep fully invested. And it would afford a better opportunity to adjust bank borrowing downward to the extent that drives for non-banking funds are successful.*

5. In addition to a National quota, the fixing of quotas by Federal Reserve Districts and within districts has been discussed. It is suggested that the fixing of such quotas for a drive aimed at non-bank investors is very difficult on any reasonable and continuing basis and that it is more likely to impede than to accelerate the sales effort. On the other hand, the fixing of quotas by districts and

*To encourage a further use of War Loan deposit accounts, and possible bank borrowing to subscribe to Government securities, consideration should again be given to the question of the requirement of a reserve against Government deposits and the Federal Deposit Insurance Corporation assessment against such deposits. It would seem that the latter, at least, should be eliminated since these secured deposits create no risk for the Federal Deposit Insurance Corporation and since this would facilitate the Treasury's financing program.

even within districts for bank subscriptions is a much less difficult job and is more nearly comparable to fixing an underwriters participation than to fixing a sales quota. It would have the advantage of helping to spread the load within the banking system and of impressing upon individual banks their responsibility for the success of each financing.

Undoubtedly other questions will have arisen in other districts, or will arise during the remainder of the December campaign, and should be added to this list of questions to be discussed with the Treasury.

Whenever the present drive ends, immediate steps should be taken to begin organizing for the next drive. Even three months is not too long for the thorough preparation which will be needed if we are to increase substantially the amount of funds obtained from non-bank investors.

December 10, 1942.