BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date July 27, 1944

To Chairman Eccles

Subject:

From Mr. Carpenter

One of the items on the agenda for the meeting of the executive committee of the Federal Open Market Committee tomorrow is the question of the action to be taken to meet the declining System reserve ratio. A memorandum prepared by the Division of Research and Statistics on this matter is attached.

Attachment

R&S 917
7/27/44

THE SYSTEM'S RESERVE RATIO

Prospects for the ratio.--Outflows of currency and of gold, the two most important factors that are causing the System's reserve ratio to decline, continue unabated. Currency flowed into circulation as rapidly in the first half of 1944 as it did in the same period of 1943. The gold loss has been more rapid than in 1943. No slackening of these elements is in sight.

While the Fifth War Loan Drive was in progress the currency outflow was somewhat smaller but it was not much different from experience during earlier drives. The experience of the other countries at war, including Great Britain and Canada, where the war costs are met to an even greater extent by taxes, shows that currency has continued to expand after income and production leveled off. The currency outflow might very well continue after the end of the European phase of the war. If reconversion of productive facilities to civilian uses gets underway, so that aggregate production and income continue at their present high levels, it is quite possible that there will be almost as much currency outflow as at present.

Gold outflow is also likely to continue. Our net import balance on private account may fall off at the end of the European phase of the war but such a change is by no means certain or even likely. Imports to this country far from shrinking, might actually expand if enough shipping should become available. As long as there is a strain on our aggregate productive capacity there is also some doubt as to the rapidity with which private exports could be built up. This situation is not likely to continue for long. When lend-lease exports stop and holders of balances here begin to utilize them, the movement is likely to be reversed. But that is not likely to occur for some time after the cessation of hostilities.

Changes in the reserve balances of member banks at the Reserve Banks have so far played very little part in the decline of the System's reserve ratio. Increases in required reserves have been about equal to the shrinkage of excess reserves. If deposit expansion continues, however, there will soon have to be a net increase in member bank reserve balances, and therefore a need for additional reserves by the Reserve Banks against these deposits.

This re-examination of the probable course of these three factors leaves the expectations as to the level of the reserve ratio unchanged from the forecast made near the beginning of the year: about 50 per cent or slightly less by the end of calendar 1944 and 40 per cent by the end of 1945. Forecasts of these factors are shown for the following 18 months in the table below.

Federal Reserve Bank:	June 30, 1944	Forecast for:		
		Dec. 31, 1944	June 30, 1945	Dec. 31, 1945
Reserves	19.3	18.7	18.3	17.9
Deposits	15.4	16.6	17.8	19.0
F.R. notes outstanding	18.9	21.9	23.9	25.9
Liabilities requiring reserves	34.3	38.5	41.7	44.9
Reserve ratio	56	49	45	40

The low point in the Federal Reserve ratio may come at the time when currency ceases to expand, and when currency begins to flow back the ratio will improve considerably. The uncertainty about the factors that have caused the currency outflow makes it equally difficult to name a time for the likely turning point. Any quick shrinkage in the aggregate of income combined with growing availability of consumers' goods and the disappearance of black markets would probably stop the currency outflow. But, as has already been suggested, there are many reasons to expect that production and income will remain high through the end of the Japanese war and will not decrease until there is a general cessation of war production.

If the war should continue somewhat longer than now expected the expansion of both currency and deposits could reach such levels that even with allowance for a post-war reflux of currency the System's reserve ratio would tend to hover around the 40 to 45 per cent level, uncomfortably close to the legal minima. This would mean currency and deposits about one-fifth or one-sixth above present levels. This contingency is remote but by no means impossible.

<u>Possible solutions</u>.--The problem posed by the declining reserve ratio to the System is two-fold. First, to frame its plans for countering or nullifying the declining tendency, and secondly, to assure the Government security market and the financial community generally that the declining ratio will not impair either the power or will of the System to pursue its objectives of stabilization. So far public comment on the decline of the ratio has not been, except by chronic critics of System policy, of an alarmist nature.

A variety of administrative steps, some of them requiring Treasury cooperation but none of them requiring legislation, could be used to meet a relatively small deficiency in the legal reserve requirements of the System: use of the Treasury's authority to issue greenbacks; monetization of free silver; activation of such free gold in the stabilization fund as is not required to meet our contributions to the monetary stabilization fund or the accompanying bank; or withdrawal of the Federal Reserve Bank notes now outstanding for use as Reserve Bank reserves. None of these steps would make a substantial change in the ratio, so that unless it were clear that the deficiency faced were to be a small one (a point on which assurance cannot be given), they would not meet the situation. The use of several of these small corrective steps would subject the System to criticism and make the problem appear greater to the public than it actually is.

A reduction in member bank reserve requirements would make a somewhat larger readjustment in reserve position than any one of the single measures enumerated above. According to the law, however, changes in member bank reserve requirements are to be used "to prevent an injurious expansion or contraction of bank credit", not to adjust Federal Reserve Bank reserve requirements.

The two measures that would be a complete solution to the problem would be (1) issuance of Federal Reserve Bank notes rather than Federal Reserve notes, or (2) reduction by law of Federal Reserve Bank reserve requirements. Suspension of reserve requirements by the Board would also offer a solution but the power to suspend would appear to be intended only for temporary emergencies, not for prolonged use.

The advantage of issuing Federal Reserve Bank notes is that no added Congressional authority would be needed, and the solution is consistent with the problem since it would be use of an emergency authority to meet an unusual expansion of currency. The disadvantages of issuing Federal Reserve notes would be the risk of reviving the criticism and mistrust that followed the paper-saving issuance in 1943. This criticism can be avoided in part by issuing the notes in the regular way which involves a $\frac{1}{2}$ per cent tax. It should also be mentioned that a bill prohibiting the issuance of Federal Reserve Bank notes has passed the Senate, with the System's concurrence, and is pending in the House. But the change in the situation since that time could be explained to Congress.

The advantage of seeking a legislative reduction of Reserve Bank reserve requirements is that it would avoid the criticism that would follow a purely administrative solution and would put the responsibility squarely on Congress. It can also be argued that a reduction of requirements is logical even though our fundamental gold reserve position remains very strong. The organization of our system of reserve requirements is such that a demand for currency, one part of our money supply, increases the demand for Federal Reserve Bank reserves six or seven times as much as a growth in demand deposits, the other segment of our money supply. Putting the matter before Congress could be viewed as a disadvantage, but it can also be argued that administrative agencies of the Government should be subjected to legislative scrutiny when basic changes are contemplated.

The System's choice between issuing Federal Reserve Bank notes and seeking a legislative reduction of requirements does not have to be made now. It can be deferred until the prospects are somewhat clarified. Waiting has the advantage that with a quicker termination of war than expected the problem may never arise. With the ever improving war news on both fronts a major turn in monetary trends may be closer than now appears.