Form F.R. 131

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date January 21, 1937.

To Chairman Eccles

Subject: Proposal to exempt time deposits from a rise in reserve requirements

From Lauchlin Currie
L.C.

In the light of the discussion on Tuesday I have written up my proposal. I think I have met all the objections and have made out a stronger case than I made in the meeting.

I think you will be particularly interested in the point on the bottom of p. 7.

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PROPOSAL TO EXEMPT TIME DEPOSITS FROM A RISE IN RESERVE REQUIREMENTS

The problem

It is the duty of the Board to prevent an injurious expansion of credit. There are strong arguments, that will not be entered upon here, for doing this by absorbing excess reserves through raised reserve requirements before engaging in open-market sales. Raising reserve requirements, however, has the disadvantage of lessening the attractiveness of membership in the System and of making it difficult to secure unification, or at least uniformity in reserve requirements as between member and non-member banks. The problem, therefore, is to raise reserve requirements in such a way as to minimize the worsening of the competitive position of member banks.

The competitive position of country member banks

There appears to be little danger of defection of city member banks because of increased reserve requirements. The question, however, is not so clear in the case of country banks. A comparison of the legal reserve requirements of country member and non-member banks is not unduly unfavorable to member banks. The fact, however, that almost all States permit legal reserves to be held in the form of vault cash and balances with other banks radically changes the picture. All country banks find it necessary to hold assets in the form of vault cash and bankers' balances. In most cases, therefore, legal reserves on deposit with the reserve banks are a net addition to the amount of non-earning assets country member banks must hold in comparison with country non-member banks.

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It is difficult to assess the importance of this factor. The fact that there is little correlation between the proportion of member to non-member banks and the relative reserve requirements in various States suggests that other factors have been more important in the past in affecting decisions to join or not to join the System. On the other hand, the doubling of previous country member bank reserve requirements would unquestionably tend to make this factor a more important consideration in the future. That country member banks are alive to the issue is indicated by the letters of protest the Board has recently received.

A possible solution

It has been suggested that if a compromise is made it should take the form of a complete exemption of country banks from increased reserve requirements. Such a course, however, appears to be open to very serious objections:

1. Since country member banks have a higher percentage of excess reserves than city banks their complete and explicit exemption would be interpreted as a sign of weakness on the part of the Board, and its prestige would thereby suffer.

2. By resulting in a greater spread between the reserve requirements against demand deposits in city and country banks, the shift of deposits and reserves from city to country banks that normally occurs in the upswing would permit a further expansion of demand deposits, or means of payment.

3. It would prove very difficult at a later date to raise the reserve requirements of country banks alone.

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Suggested solution

It is suggested that the problem could be most effectively met by exempting time deposits from a rise in requirements.

1. Substantial relief will be afforded country banks with little diminution in the net effectiveness of action if the rise in reserve requirements were confined to demand deposits. On the basis of the November 1-15 figures and in comparison with the rise of 33 1/3 percent against all deposits, it would reduce the increase in requirements for country banks by one-third. The net difference for all banks, however, would be only $160 million, or ten percent. This follows from the facts that demand deposits in the System are more than double time deposits, that a 33 1/3 percent rise in the already relatively high requirements against demand deposits amounts to many more percentage points than an equal percentage rise against time deposits, and that city banks hold 80 percent of the demand deposits while country banks hold 50 percent of the time deposits. The absolute and percentage differences for various classes of banks are indicated in the following table:

Classes of banks	Excess reserves (First half of Nov.)	Amount that would be absorbed by		Percent that would be absorbed by	
		Flat 33 1/3 percent increase	33 1/3 percent increase on demand deposits alone	Flat 33 1/3 percent increase	33 1/3 percent increase on demand deposits alone
Central reserve city bks.					
New York City	734	646	636	88.1	86.8
Chicago	216	143	137	66.1	63.2
Reserve city banks	720	487	421	67.7	58.5
Country banks	529	244	163	46.1	30.8
All member banks	2,199	1,521	1,357	69.1	61.7

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2. In addition to country banks, substantial relief will be afforded reserve city banks in the San Francisco district whose time deposits are large relative to their demand deposits. On the basis of the November 1-15 figures a uniform 33 1/3 percent increase would absorb 107 percent of the excess reserves of these banks, whereas a 33 1/3 percent increase against demand deposits alone would absorb only 78 percent. As pointed out below, these percentages will probably be higher by the time action is taken.

3. It is to be anticipated that the $160 million difference would result in less utilization of bankers' balances and hence would afford some relief to the New York banks.

4. The effectiveness of action would not be impaired by a reduction of $160 million in the excess reserves absorbed. Up until recently it was anticipated that the exercise of the full remaining power would leave banks with $700 million excess reserves, and that member banks would receive further accessions of reserves from declining currency and inflowing gold. The picture has recently undergone considerable change. The Treasury proposes not only to prevent further inflows of gold from creating excess reserves but, by its action, will undertake to reduce excess reserves. Moreover, by making its action in effect retroactive it apparently proposes to reduce excess reserves by some $150 million more than we anticipated. Finally, it now appears that currency in circulation will continue to increase. Hence, there is a

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likelihood that if full action is taken soon, banks will be left not with $700 million, but with nearer $500 million excess reserves, and there appears to be good reason to believe that unless the reserve banks buy bills or securities the excess reserves will be absorbed and banks will be forced to borrow before the year end.

Since, therefore, the picture has undergone such a drastic change, there would appear to be good reason for lowering somewhat the amount of absorption originally contemplated at this time. It would be undesirable to do this by exempting a particular class of bank or by lowering the percentage rise against all deposits. It could be accomplished, however, by exempting time deposits.

5. It would not appear unduly difficult to raise reserve requirements against time deposits at some time in the future if it should be thought desirable. The point has been made that the same difficulty would arise as would attend an attempt to raise reserve requirements for country banks alone. There is a significant difference, however, between explicitly singling out a particular class of <u>bank</u> and a particular type of <u>deposit</u>. So far as I know, nobody has made the point that the determination of the maximum rate of interest payable on time deposits is directed at <u>country</u> banks. If it were desired to raise reserve requirements against time deposits in the future it would presumably be done at a time when time deposits were explanding or interest rates were rising, and it would either reinforce or serve as an alternative to a rise in the maximum rate of interest payable on time deposits.

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In this connection it is worth pointing out that very few people are aware of the distribution of deposits or of the incidence of the burden of raised reserve requirements against time deposits. In any case, city banks hold as many time deposits as do country banks.

6. The specific proposal under discussion impinges on the broader problem of the advisability of differencesin reserve requirements as between time and demand deposits. As reasons for not widening the present spread in requirements it has been claimed that this course would increase the inducement for classifying active deposits as time deposits and would result in numerous attempts at circumvention, that time deposits are in effect payable on demand and hence should carry the same requirements as demand deposits, and that lower reserve requirements against time deposits permit a greater expansion of total bank deposits. I shall take up these points in order.

a. Inducement for reclassifying deposits. It is difficult to see the force of this contention. Bankers pay no interest on demand deposits and there would be no point in a person carrying a time deposit rather than a demand deposit unless he received interest. In the specific case at point the additional inducement to the bankers would be the interest they can secure on the released reserve that amounts to $1\frac{1}{2}$ percent of the deposit. It is obvious that the additional interest banks would have to earn on this $1\frac{1}{2}$ percent in order to pay interest to the depositor on the total deposit would be impossible to secure. The same is true if the released reserve amounts to $9\frac{1}{2}$ percent ($14 - 4\frac{1}{2}$) or $15\frac{1}{2}$ percent or even $21\frac{1}{2}$ percent. In the last instance, the rate of interest that would have

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to be earned on the released reserve would have to be five times the rate paid on time deposits.

If, of course, it were a case of the demand depositor removing his deposit altogether from the bank in order, for example, to buy securities, it would probably be to the bankers' interest to solicit the deposit as a time deposit. This, however, is quite different from reclassifying existing deposits that would not otherwise be withdrawn from the bank. Finally, in this connection it is worth pointing out that the regulations now in force against checking against time deposits appear to be fairly strictly enforced.

b. Time deposits payable on demand. It is now generally agreed that the purpose of legal reserves is not to provide liquidity but to furnish a means of control. For liquidity banks must rely on their secondary reserves. Moreover, time deposits normally increase steadily and are drawn out only in a severe depression. Even in 1930 they increased.

c. Greater expansion of total deposits permitted. While this is true, the further inference that this is a bad thing should not be drawn. In terms of the flow of money, savings that take the form of increased time deposits result in a diminished flow and lower incomes than savings that take the form of direct investment. In the former case not all the savings of the individual are passed along by the banker to the ultimate borrower to be disbursed. In the latter case all the savings

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are passed along. The danger lies in concentrating on banking figures alone and overlooking the total community flow of money. Raising reserve requirements against time deposits, by impeding the expenditure of current savings, would run counter to our attitude on the tax on undistributed earnings and on social security taxes, an attitude that is based on our fear that over the longer term savings may be excessive relative to the opportunities for investment in durable goods.

7. The press statement could explain an exemption of time deposits, if it were thought necessary to make an explanation, in terms of the fact that it is desired to leave banks with over $600 million excess reserves so that they can meet the currency needs, etc., of the remainder of the year without borrowing or without reserve banks buying securities. It is thought undesirable to exempt any class of bank or to leave a small part of the power to raise reserve requirements against all deposits unexercised. By confining the rise to reserve requirements against demand deposits, an amount of absorption of excess reserves which is thought about right in the present circumstances would be achieved. It might possibly be mentioned that time deposits have experienced little expansion as yet.

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January 25, 19371

LBC.

EXAMPLES ILLUSTRATING THE RESTRICTIVE EFFECT OF RESERVE REQUIREMENTS AGAINST TIME DEPOSITS

Example I - Assume $1 billion of savings out of current income go annually into savings or time deposits. Assume reserve requirements against time deposits to be 6 percent and the average against demand deposits to be 20 percent.

On $1 billion shift from demand deposits to time deposits represented by current savings, the released reserve, amounts to $140 million. ($200 million minus $60 million). Banks can expand their loans and investments by $700 million ($140 million multiplied by 5, the ratio of expansion of demand deposits). Hence, out of $1 billion saved only $700 million is passed along to borrowers to be disbursed. If, instead of increasing their time deposits, savers had invested their savings directly, a full $1 billion would have been passed along to borrowers, etc. To offset this diminution in the flow of money additional reserves of $60 million dollars would have to be furnished banks so that they can increase their loans and investments by an additional $300 million ($60 multiplied by 5).

Example II

Same assumptions as before, except that reserve requirements against time deposits remain at 4½ percent.

On $1 billion shift from demand deposits, the released reserve amounts to $155 million ($200 million minus $45 million). Banks can expand their loans and investments by $775 million ($155 multiplied by 5).

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To ensure that the full amount of savings are passed along to borrowers additional reserves of $45 million would have to be furnished banks so that they could expand their loans and investments by an additional $225 million ($45 million multiplied by 5).

Conclusion

From the point of view of maintaining the flow of purchasing power reserve requirements against time deposits should be kept as low as possible. Ideally they should be zero, so that the full amount of savings would be passed along whether the saver bought a bond, etc., directly or increased his time deposits.

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