

Exhibit C

June 19, 1940

PROPOSALS TO CONTROL BANK RESERVES

by

Victor M. Longstreet

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This memorandum discusses various proposals that would enable the monetary authorities to regain control over the maximum amount of credit that banks may extend. The proposals comprise various methods of controlling the volume of reserves available as a basis for bank credit. They have been advanced because the present controls are inadequate.

Excess reserves of member banks now amount to \$6,500,000,000. The maximum amount of excess reserves that the Federal Reserve authorities can now absorb theoretically by ordinary methods at their disposal is about \$5,000,000,000, measured as follows:

- (1) The open-market portfolio of \$2,500,000,000.
- (2) An increase in reserve requirements by about 1/7 to the full amount permitted by the Federal Reserve Act; this would at present amount to about \$1,000,000,000.
- (3) Reclassification of country and reserve city banks as central reserve city banks after increasing requirements under (2) above would absorb an additional \$1,200,000,000.
- (4) Calling in the unpaid capital stock of the Federal Reserve banks would amount to \$140,000,000.

An inflationary expansion of bank credit on the basis of existing excess reserves and future increases in reserves, therefore, would be beyond the present powers of the Federal Reserve System to control through the medium of reserves. Even though bank credit did not expand further, the turnover of deposits already in existence could increase to a point where they could finance an inflation greater than this country has ever experienced. At the present time the turnover of deposits is the lowest on record. Consequently, the monetary authorities need powers sufficient not only to prevent a further growth in the volume of bank credit but also to effect a contraction in this volume if an inflationary movement should result in a rapid turnover of existing deposits. Some of the proposals considered below are designed to limit the further growth of bank credit, while others could be used also to effect a credit contraction. There may be an advantage in combining certain features of the various proposals and several possible combinations are discussed at the end of this memorandum.

Treasury Sterilization

Treasury sterilization and the issuance of debentures by the Federal Reserve banks as a means of absorbing bank reserves are basically similar in their operation to the Federal Reserve's selling Government securities in the open market. For these methods can be applied gradually or rapidly in desired amounts, policy can be readily shifted, and they work more or less through money markets without requiring any action on specific banks.

Treasury sterilization of funds for the purpose of insulating banks against the effects of further gold imports was tried in 1936-1938. This was accomplished by the Treasury's buying gold with the proceeds of Government securities sold to the market and refraining from the issue of new gold certificates in payment for the gold acquired.

A sterilization program would not have to be exactly of the variety in effect during 1936-1938. The Treasury can sterilize gold that has already entered into our banking system as well as gold freshly acquired, and this can be done with tax revenues as well as with proceeds from security issues. That is to say, the volume of excess reserves could be reduced if the Treasury sterilized a part of such funds by retaining them on deposit with the Federal Reserve banks. This would effect a transfer of reserves from the balances of member banks. The Treasury could either maintain its Federal Reserve deposit at the higher level or utilize the funds to liquidate a part of its issue of gold certificates or gold credits held by the Reserve banks, thus transferring an equivalent amount of gold to an "inactive account".

Under a program of Treasury sterilization, therefore, monetary policy ties in closely with fiscal policy. Unless the sterilization operations are on some automatic basis, that is, nondiscretionary, as they were in 1936-1938, or unless the law specifies that they are subject to the direction of the Federal Reserve authorities, the Treasury would currently determine the country's credit policy. The Treasury would bear the cost of sterilization. This cost would be measured by the interest paid on securities that were issued for the purpose of sterilizing funds or by the interest paid on the securities that could have been retired with whatever taxation receipts were required for the sterilization program.

Issue of Debentures by the Federal Reserve Banks

Issue of debentures created by the Federal Reserve banks or the Open Market Committee has been advocated as a way of supplying the Committee with additional open-market material if its holdings of Government securities were exhausted. Such a provision was contained in the Goldsborough Bill of 1932 (H. R. 10517).

The only objection that has been offered against this proposal, though it may be a crucial one, is the cost involved. With no Government securities and few or no discounts, the Reserve banks might be unable to meet current expenses, and certainly not interest charges on a considerable volume of debentures.

Congress could provide for the Treasury to reimburse the Federal Reserve banks for the cost of issuing the debentures. If this were done the scheme would be, mechanically, much the same as Treasury sterilization by issuance of Government securities. The difference would be in the location of authority. Issuance of Federal Reserve debentures would clearly place responsibility for credit policy in the hands of the Federal Reserve authorities instead of the Treasury.

A question has been raised why the Federal Reserve banks should go to the expense of printing and issuing debentures in the market when payment of interest on excess reserves of banks might accomplish the same purpose. If banks received interest on excess reserves, banks would be encouraged to retain them idle and thus reap the same income as if they had bought Federal Reserve debentures. During the First World War, the Bank of England paid interest on bankers' balances for short periods.

Straight Increase in Reserve Requirements

Proposals to raise reserve requirements range all the way from authority to raise requirements without essential change in the reserve mechanism to the extreme proposal of requiring 100 per cent requirements against all demand deposits. How any of these plans will work out in actual practice is bound to remain more problematical than the effects of either Treasury sterilization or issuance of Federal Reserve debentures, which are analogous to the familiar open-market operations. An increase in reserve requirements, however gradual, may have important and unpredictable psychological effects on the market and will also affect the banks' future earning power. An essential part of any scheme for raising reserve requirements is that it should apply to all banks in the country, or that banks exempted from its provisions should be definitely restricted in the scope of their operations,

The Board's power to increase reserve requirements to twice statutory requirements is almost completely utilized. Proposals to extend this power have assumed two main forms:

- (1) Complete elimination of statutory restriction on the Board's power.
- (2) Permit increases in reserve requirements sufficient to absorb all excess reserves due to:
 - a) additions to the active gold supply, or
 - b) additions of funds from all sources except open-market purchases of securities by the Reserve banks,

Provision could be made under (2) that increases in requirements may not reduce excess reserves below, say, \$1,000,000,000, or some specified amount within the limits of control by the System's open-market portfolio. A figure of \$1,000,000,000 is \$1,500,000,000 less than the present portfolio. The proposal under (2,b) would permit the Board to absorb all additional reserves arising from gold imports, spending of Stabilization Fund, issuing of silver certificates, and return of currency from circulation.

At the time reserve requirements were increased other action could also be taken by the Board to offset possible adverse effects of the increase. For example, banks with inadequate reserves might be relieved from paying a penalty rate for incurring a reserve deficiency. The Board could also undertake open-market purchases of securities in sufficient amounts and at the proper times to prevent any disturbances that an increase in requirements might cause in the bond market.

100 Per Cent Reserve Plan

The 100 per cent reserve plan provides that all demand deposits shall require 100 per cent cash reserves and that time deposits shall be exempt from any reserve requirements. Most versions of the plan would place further restrictions on the possible use of time deposits for making payments. Advocates of the plan propose it not as a solution to the problem of excess reserves, but on broader grounds of divorcing the money supply from the lending and investment activities of the banks. This plan has been proposed in several bills in Congress and has received such wide Congressional and academic support that it is worth considering in some detail.

Control of the quantity of money.

Demand deposits, the proposal states, could not be diminished by a reduction in bank loans and investments but only by gold outflows or by action of the monetary administration, i. e., through sales of securities, collection of advances, etc. On the other hand, demand deposit

expansion would occur and could only occur when gold was imported or when the monetary administration purchased securities or made advances to lending institutions. There would no longer be the possibility of a multiple contraction and expansion on the basis of reserve funds. The scheme is believed by its advocates to give the monetary administration direct and precise control over the volume of demand deposits.

It is denied by some that the proposal gives complete or even greater control over the volume of bank demand deposits. The substance of this criticism is that regardless of whether reserve requirements are 10 per cent or 100 per cent, if bank loans are repaid or bank investments sold, the funds will come out of demand deposits and result in a decline of such deposits. Nor would this situation be altered by a division of banking between (1) deposit departments or separate depositaries that would hold demand deposits covered fully by reserves and (2) lending and investing departments or separate institutions that would accept time deposits. When loans were called or otherwise reduced by these lending institutions, which would keep their working cash in balances with the depositaries, their balances at the depositaries would increase and deposits held by the public would correspondingly diminish. Although this would not reduce total demand deposits, there would be a decrease in the amount of demand deposits held by business, governments, and individuals, which are the deposits available for use and those corresponding to present demand deposits excluding interbank deposits.

Control of business activity.

The 100 per cent reserve plan provides that the regulation of the supply of demand deposits shall be the principal or sole responsibility of the monetary authority. The ultimate aim of the plan is to maintain business activity, employment, and income at some desired level through regulation of the money supply. Implicit in the plan is the faith that economic activity can be regulated by changes in the volume of money as the proponents choose to define money.

Introduction of the plan.

To introduce the plan would present a number of problems. Since banks would not have sufficient cash reserves, Government securities could be temporarily substituted as reserves. Some versions propose that the Reserve banks should buy assets from commercial banks sufficient to provide the additional reserves required. This would deprive the commercial banks of earning assets and raises the question of future sources of income and higher service charges. Several methods have been suggested by which the Government might reimburse banks for their services in handling the deposit and checking facilities of the country.

Perhaps the most widely suggested method of furnishing banks with 100 per cent reserves provides that the Reserve authorities make loans to banks on noninterest-bearing notes secured by a general lien on the banks' assets, thus permitting banks to continue to receive income from their present earning assets. In that case, however, the plan would not result in retirement of a large portion of the Federal debt by the banks exchanging Government securities for new currency issues, which some present as an argument for the plan.

Treatment of time deposits.

Another question that has received considerable attention is the treatment of time deposits. So long as time deposits represent genuine savings it may be considered desirable for economic progress that they should be reinvested, although this may not be true in an inflationary period. If 100 per cent reserves were required against savings deposits part of the current savings would be withdrawn from active use--a deflationary development. On the other hand, it is desirable that the scheme should not encourage the development of artificial savings deposits that would be subject to large fluctuations or would be used in effecting business settlements in circumvention of the plan's purpose. A bank would be under an inducement to build up its time deposits because they could be loaned and invested.

The problem of time deposits might be met in various ways. The functions of banks could be segregated or investment trusts developed to take over the saving and lending functions of present commercial banks. Banking institutions could also act as intermediaries between prospective borrowers and lenders. Time deposits could be converted into medium-term negotiable obligations of the banks. A size limit on the individual time account might be adequate safeguard against abuse.

Future financing of bank customers,

Under all versions of the plan banks would still have the proceeds of time deposits to lend and invest. Some variations permit banks to retain all of their earning assets, which could continue to serve as a revolving fund for loans and investments, but which could not be increased except to the extent that time deposits increased. If the Reserve banks rediscounted or made advances to banks for the purpose of making loans, reserves obtained in this way would support a dollar-for-dollar expansion of credit. Whether or not the tradition against borrowing would break down under the 100 per cent system, which would reduce the need for liquidity both for the individual bank and for the banking system as a whole, is a matter of conjecture. In any case, it is claimed that the power to vary the discount rate would give the Reserve administration sufficient control.

It has also been suggested that bank borrowers be accommodated by the Reconstruction Finance Corporation or other Government lending agencies. Certain new types of credit institutions might also develop, depending on how the banking system were affected by the plan,

Conclusion.

The 100 per cent reserve plan would absorb all excess reserves. It would seem, therefore, to furnish the monetary authorities with adequate power to prevent credit expansion or cause credit contraction, depending on the size of the loophole left by the ability of banks to make loans and investments out of time deposits. The significant question is whether we need for this purpose such a drastic revamping of our banking system as the 100 per cent plan proposes. A basic criticism of the philosophy underlying the proposal was summarized in the Board's statement of July 30, 1937, as follows:

"The Federal Reserve System can regulate within limits the supply of money but there are other factors affecting prices and business activity fully as powerful as the money supply. Many of these factors are nonmonetary and cannot be controlled by monetary action. Their effect on business activity may express itself in an increased or decreased rate of use, or turnover, of the existing supply of money as well as in a change in the supply itself."

Ceiling Reserve Plan

The ceiling reserve plan would provide a formula for assigning to each bank a figure, called its "ceiling", that would be equal to or somewhat above the bank's existing level of demand deposits. Demand deposits below the ceiling would continue to be subject to the regular fractional reserve requirements and all demand deposits above the ceiling would require dollar-for-dollar reserves. The plan could provide for periodic reallocation of the ceilings of banks in order to readjust for the shifting of demand deposits among banks.

All time deposits may be exempted from the plan and continue to require regular reserves. If this were done, some limitations on time deposits would have to be imposed, as in the case of the 100 per cent reserve plan, in order to prevent circumventions. Such limitations are necessary because a multiple credit expansion would still be possible at banks if their time deposits were increasing.

Operation of the plan.

The ceiling plan was devised for the purpose of making possible an increase in reserve requirements without forcing any bank to borrow or to liquidate assets. It thus avoids one of the chief objections urged against straight increases in reserve requirements. In view of the extremely large volume of excess reserve now in existence, however, the ceilings might have to be determined at a level that would require some banks to liquidate assets. At banks with excess reserves, ceilings could be placed below the existing level of deposits without

hardship. If ceilings were equal to or somewhat above each bank's existing deposits, then the adoption of such a plan would probably not affect the total volume of excess reserves nor their distribution among banks. Further credit expansion would be limited to the amount of remaining excess reserves; multiple credit expansion would be eliminated. That is, each bank could use its excess reserves to increase its loans and investments, but as the funds were deposited, they would have to be backed dollar-for-dollar by reserves and would not be available for further credit expansion. Deposits would be increased by gold imports or by various other factors that add to the supply of bank reserves, but they could not be used for increasing loans and investments.

The way the plan would work may be illustrated as follows. If the plan were put in operation now for all member banks and the ceiling for each bank placed at its present level of net demand deposits, the aggregate ceilings for all banks would be \$32,000,000,000. Reserves required against these demand deposits would remain unchanged at \$6,300,000,000, and requirements against time deposits at \$600,000,000. Excess reserves would also remain unchanged at \$6,500,000,000.

Existing excess reserves could still be utilized by the holding banks for lending or investing. However, if banks began to lend or invest their excess reserves, the banks would have to hold special dollar-for-dollar reserves against the new deposits. When a bank received new deposits and reserves loaned by other banks, it would have its regular reserve requirements increased by the full amount of the increase. The proposal would thus not cause a bank to contract credit; it would prevent a bank lending new reserves.

If the plan should be put in operation in this way, total expansion of demand deposits would be limited, in the absence of additional reserves, to \$6,500,000,000. If banks should gain additional reserves through gold imports or otherwise, there would be a growth in demand deposits equal to but not in excess of the additions to reserves. There would not be any increase in the lending or investing power of the banks because the reserves gained would have to be held dollar-for-dollar against the new deposits.

Adjustment of ceilings,

Under the plan, it might be desirable to provide for a readjustment of ceilings of banks from time to time. Without provision for adjustment of ceilings, growing banks or growing communities might not be able to expand bank credit, though their bank deposits were increasing. It might be desirable to prevent this expansion, however, if there were a general inflationary development. Moreover, without readjustment of ceilings, banks that were rapidly growing might eventually have to hold as required reserves a proportion of their deposits that would be grossly out of line with the position of banks whose deposits were declining.

In order to prevent the plan from operating in this manner, ceilings of banks could be readjusted from time to time. Banks losing funds would have their ceilings reduced periodically. This reduction would not have to be below the actual level of their demand deposits. The aggregate of such reductions would then be reallocated among banks gaining the reserves. With these reallocations the banks gaining reserves would be in a position to expand their loans and investments to the extent that other banks were contracting loans and investments,

It is believed that such a mechanism of reallocation could be made simple and equitable and that, once understood, it would not cause confusion or uncertainty. Details of a possible method of reallocation are shown in Exhibit A.

Capital-ratio Reserve Plan

The capital-ratio reserve plan might be considered a variation of the ceiling reserve plan in that it also would require 100 per cent reserves against deposits beyond a fixed amount, thus aiming to eliminate the multiple expansion of credit by banks on the basis of their existing excess reserves and future additions to reserves. It differs from the ceiling plan in two ways: (1) ceilings are determined on the basis of the capital position of banks, and (2) in addition to preventing undue credit expansion, the capital-ratio plan also is intended to encourage sounder capital positions at individual banks.

The capital-ratio plan has appeared in several variations. One of them has been introduced in Congress in the Mead Bill (S. 3867), which has been analyzed in a separate memorandum. In the form provided by the Mead Bill, however, the capital-ratio plan would necessitate credit contraction upon inauguration at a number of individual banks, while in the long run it would not control credit expansion effectively. The plan discussed below is modeled along the lines of the Mead plan with such amendments as are necessary to render it more effective in controlling credit expansion.

Operation of the plan.

The Board would be given the power to establish a standard ratio of deposits to capital as a basis for determining the reserve requirements of banks. Maximum and minimum limits to the Board's ratio could be imposed by law if this were thought desirable; these were 12 to 1 and 6 to 1 in the Mead Bill. This ratio would be applied as follows:

- (1) For banks with a deposit-capital ratio below the standard when the plan is adopted, all deposits will continue to require only fractional reserves until an increase in their deposits raises their ratio to the standard ratio. Thereafter, any increase in their deposits will require 100 per cent reserves.

- (2) For banks with a ratio above the standard when the plan is adopted, their existing volume of deposits will always require only fractional reserves. Thereafter, any increase in their deposits will require 100 per cent reserves.
- (3) The amount of capital of each bank when the plan is adopted would be used thenceforth in computing deposit-capital ratios of banks under the plan.

Under (1) and (2) the plan would not immediately affect the volume or the distribution of excess reserves. Therefore, every bank could lend or invest all excess reserves held at the time the plan was adopted, just as under the ceiling proposal.

Credit expansion would not, however, be limited to only the volume of excess reserves. Banks whose deposit-capital ratios were lower than the Board's selected standard could, under (1) above, lend all of their new deposits after the setting aside of required reserves. And they could do so until their deposit-capital ratios reached the Board's standard. The limit to future credit expansion would depend, therefore, on the Board's standard ratio, a high ratio permitting more expansion than a low ratio.

By virtue of the provision under (3) above, no bank could reduce its reserve requirements by increasing its capital. In order for the Bill to be effective in restricting credit expansion, banks should not be permitted to evade the credit control provision by increasing their capital. This does not mean that banks would not be permitted to increase their capital; but if banks did increase their capital, such increase would not figure in the computation of the ratio of deposits to capital accounts. That is to say, banks might be permitted to increase their capital, but they could not as a result of this increase free any of their 100 per cent required reserves for the purpose of additional credit expansion.

The measure would provide a method of restricting credit expansion, but it would become effective only after substantially all banks would have expanded to the limits permissible under the proposal. Without the provision under (3) above, the proposal would do little to prevent credit expansion; for banks would want to expand their loans and investments at the very time when money rates, prices, general business activity, and bank profits were generally increasing. Under such circumstances it would be easy for banks to build up their capital either through retention of earnings or issuance of new capital shares.

Likewise, the provision under (3) above would also be necessary in order to prevent banks from being forced into a deficient reserve position because of a loss of capital. Without this provision, a bank that was losing capital, perhaps because it was writing off losses on loans or investments, might have its reserve requirements increased.

The bank would be compelled to liquidate assets just at the time when its capital position was weakening,

One variation of the plan uses ratios of total loans and investments to capital instead of deposits to capital. This variation provides a better measure of the adequacy of a bank's capital. It raises some difficult questions, however, about the placing of a fair valuation currently upon a bank's loans and investments. There is no valuation problem, of course, as regards a bank's deposits.

Plan would not strengthen bank capital.

One of the arguments advanced in favor of a capital-ratio plan is that it would strengthen the capital position of banks. The plan as outlined above would not do this, however, because it would offer no additional incentive for banks to increase their capital nor discourage them from decreasing capital. As already explained, it is necessary to divorce reserve requirements of banks from future changes in their capital if the measure is to control credit expansion satisfactorily.

This raises the question of the desirability of relating reserve requirements to capital position in the first instance. The ceiling reserve plan, which would determine ceilings for banks on the basis of their volume of deposits, instead of their capital, would limit credit expansion in a much simpler way than the capital-ratio plan.

Reserve-bond Plan

The reserve-bond proposal has been presented by Lawrence Seltzer, of Wayne University, formerly with the Treasury Department. He suggests that for the demand deposits of a bank to be subject to fractional reserve requirements the bank must also hold a new type of Government security in an amount equal to at least 25 per cent of these deposits. Demand deposits of a bank in excess of 4 times its holdings of such securities shall require cash reserves of 100 per cent, instead of the existing fractional reserves.

Banks could obtain these reserve bonds in exchange for outstanding Government obligations. The amount of reserve bonds originally issued would be determined by agreement between the Secretary of the Treasury and the Board of Governors. Thereafter the Treasury would issue reserve bonds only in such amounts as the Board might request. Mr. Seltzer does not suggest on what basis the Reserve Board should determine the allotments of reserve bonds among banks.

In our correspondence with Mr. Seltzer, he has agreed that the effectiveness of his plan as a check to credit expansion depends upon the 100 per cent cash reserve requirement beyond the established

limits, and that the bond reserve in itself does not restrict credit expansion but merely establishes the limit for fractional cash reserves. It therefore works in fundamentally the same way as the ceiling reserve plan. In other words, permitting banks to hold reserve bonds is the equivalent of granting them ceilings, because if a bank holds deposits in excess of 4 times its reserve bonds, these excess deposits require 100 per cent cash reserves. Or, expressed in terms of the ceiling plan, a bank's ceiling would always be equal to 4 times its holdings of reserve bonds. Under the reserve-bond plan, as under the ceiling plan, banks with excess cash reserves could use them to increase loans and investments, but new deposits thus created would generally require 100 per cent cash reserves, unless they were lodged in banks with excess bond reserves.

Mr. Seltzer believes that the reserve-bond proposal is superior to the ceiling reserve proposal, not in the respect of credit control, but by virtue of the fact that it would accomplish some changes in the Government bond market, which he thinks would be beneficial--principally the feature that the bonds could be converted into cash at par whenever the Board considers it necessary. It might be possible to separate these changes from the credit control features of the plan and consider them on their own merits, but Mr. Seltzer thinks they might make an increase in reserve requirements more palatable to banks and to the Treasury.

Velocity Reserve Plan

The velocity or debits reserve plan proposed in 1931 by the System's Committee on Bank Reserves would base reserve requirements partly on the volume of debits to deposit accounts, i.e., on the turnover of deposits, as well as on the volume of deposits. Reserve requirements would increase and hence excess reserves would decrease whenever the velocity of deposits increased. It is theoretically possible under this plan to establish reserve requirements in such a way that all excess reserves could be absorbed as a result of an increase in the velocity of deposits. At the present time velocity is about 13 times a year, or two-thirds of the level of the early Twenties.

The principal objections to the plan are:

- (1) Its effects might be inequitable because of wide variations in turnover among individual banks due to arbitrary but normal differences in business and accounting practices of bank customers.
- (2) Its aims could be interfered with by banks' developing new payment methods that would reduce the volume of bank debits and hence their reserve requirements.

The second objection is crucial because the incentive for banks to develop ways of reducing bank debits would prevent the plan from being an effective credit control measure. This objection might be overcome by

retaining the basic principle of increasing reserve requirements as velocity increases but applying the increases uniformly instead of on an individual bank basis. To take an example that states the point simply, it could be provided that if bank debits for the country increased 5 per cent, reserve requirements generally would be raised by 5 per cent. No individual bank would then be encouraged to reduce the volume of debits to its own accounts. Changes in reserve requirements for all banks, in other words, could be tied to changes in the total volume of bank debits. Instead of bank debits, some general inflationary index, such as prices, could be used. Such a system would really amount to combining the present system of straight changes in reserve requirements provided by existing law with the main principle underlying the velocity reserve proposal.

In recent years the volume of deposits has grown faster than their use and excess reserves have been so large that the velocity reserve plan by itself may not solve the problem. It has the distinct advantage, however, of providing for absorption of bank reserves if an inflationary expansion is being financed, not by a growth in the volume of bank deposits, but by a more rapid turnover of existing deposits. Combined with either the system of straight increases in reserve requirements or with the ceiling reserve plan, the velocity reserve proposal might be very effective, if evasion could be prevented.

Possibility of Combining Various Reserve Plans

Control of bank reserves does not have to be confined to the use of a single plan. It might be advisable, for example, to obtain authority to permit issuance of Federal Reserve debentures, to remove the statutory limit on straight increases in reserve requirements, as well as to adopt some version of the ceiling reserve plan. The more varied the Board's powers, the better prepared it will be to cope with an inflationary situation with a minimum of disturbance to the banks and the money markets.

Separate features from each of the reserve proposals can be combined in a variety of ways. As an example, straight increases in regular percentage reserve requirements could be combined with ceiling reserve plan, the capital-ratio reserve plan, or the reserve-bond plan. Such increases might be considered necessary if the volume of credit expansion that these plans would permit is considered too large.

An effective arrangement would be to apply the ceiling reserve plan as a method of easing the transition to a higher level of reserve requirements. For example, the Board could raise reserve requirements to some figure, for example, to 35 per cent on demand deposits and 8 per cent on time deposits. Banks that would have enough excess reserves to meet the increase, would do so and thereafter would be required to hold the increased percentages of reserves against all new deposits that they might acquire. Banks, however, that did not have enough excess reserves to meet the increase would not be required to borrow or liquidate assets in order to meet the increase. They would, however, be required to hold dollar-for-dollar reserves for all new deposits until their total reserves were sufficient to cover the new requirements; after that they would operate in the usual way on the new basis.

In this form the ceiling reserve plan would be temporary. It would prevent glaring inequalities in reserve requirements from developing; that is, banks showing large future increases in deposits would not be required to keep 100 per cent reserves against such increases beyond a certain amount. Nor would the problem of periodic reallocation of ceilings be as important as under an unlimited ceiling proposal. At the same time it would eliminate the necessity for any bank to contract credit and would provide an effective check on credit expansion on the basis of existing or currently acquired reserves.

EXHIBIT A

One Possible Method of Readjusting Ceilings Under the
Ceiling Reserve Proposal

This method of readjusting ceilings under the ceiling reserve proposal is, of course, tentative and would have to be modified on the basis of experience.

For each bank there will be kept two series of figures giving for each month an average of (1) regular required reserves (fractional reserves) and (2) special reserves (dollar for dollar reserves); in both cases the figure given for each month to be an average of the three-month period ending with that month.

The original allotment of a ceiling for each bank will be equal to the highest figure in series (1) for any of the twelve months preceding the allotment. This will insure the bank from having its allotment based on a temporarily low or high level of reserves,

Periodic reductions in allotments could be based on the same series of monthly figures. If the allotment that the bank has at any time is larger than the highest figure in series (1) for the twelve months preceding, the allotment will be reduced to that amount.

All of the reductions in allotments for individual banks will be aggregated and this aggregate will then be redistributed among banks that have had increases in special reserves shown by series (2). The aggregate decreases in allotments will be compared with the aggregate increases in special reserves for all banks since the last reallocation. The percentage that the aggregate decreases in allotments constitute of aggregate increases in special reserves will be calculated. Each bank having an increase in special reserves will have its allotment increased by this percentage of the increase in its special reserves.

This method of increasing allotments would insure that a bank could increase its loans and investments on reserves acquired as a result of interbank movement of funds. It will also insure an equitable redistribution of allotments between individual banks, for adjustments would be in accordance with the growth in the special reserves of such banks and they would tend to eliminate unusually large increases in the reserve requirements of individual banks. The net result for all banks, however, will be that changes in the total volume of regular and special reserves will be almost the same as if the banking system were a single bank.