BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON

October 15, 1962.

750

TO: Federal Open Market Committee

FROM: Mr. Young

There is enclosed a copy of a memorandum written by Mr. Koch on "Government Deposits Part of the Money Supply?" This memorandum was written in response to Mr. Sternlight's recent memorandum entitled "Comments on Recent Behavior of Required Reserves in Relation to Growth Guidelines."

Ralph A. Young

Ralph A. Young, Secretary,
Federal Open Market Committee.

Enclosure

MEMORANDUM October 15, 1962

To: Federal Open Market Committee Subject: Government Deposits

From: Albert R. Koch Part of the Money Supply?

Peter Sternlight has recently written a thought-provoking memorandum entitled "Comments on Recent Behavior of Required Reserves in Relation to Growth Guidelines." In it he concludes that about half of the recent increase in Government deposits should, in effect, be considered as part of the money supply, and that the reserves made available to support such deposit expansion should be counted toward meeting a required or total reserve target.

Sternlight has made a helpful point when he suggests that we should look at the source of the change in the Government balance rather than just the end result. To put it somewhat differently, it is the effect of the size of the Government balance on the liquidity and incomes of the private economy that is important for monetary policy formulation. Here liquidity should be defined broadly, including not only liquid assets but also short-term liabilities (which are a negative part of liquidity) and the cost of borrowed funds. The relevance of this last point will appear shortly.

One may agree with Sternlight when he suggests that, in periods like the present at least, if the Government balance is increased by borrowing from the banks, generally speaking the reserves underlying such a deposit increase should be supplied to the banking system to permit bank acquisitions of Government securities without decreasing the ability of banks to make loans and acquire other securities. Private liquidity and incomes would not be reduced in these circumstances.

Reserves are in fact supplied to support the bank acquisitions of Government securities and the resulting Government deposits if the guidelines to monetary policy are free reserves, money supply, the tone and feel of the money market and/or interest rates. They are not likely to be supplied if bank credit, total deposits, total reserves, or nonborrowed reserves are the dominant guides to policy.

Private liquidity and/or incomes are certainly reduced, however, when the Treasury's cash balance is built up through tax collections or by borrowing from nonbank sources. In the tax collection case, private incomes and the money supply are reduced and Sternlight suggests (1) that the income drain is largely planned for and therefore doesn't depress spending significantly, and (2) that the reduction in the money supply overstates the total effective drain in the nation's liquidity.

In the case in point, one may wonder if Sternlight doesn't overlook an important phase of the operation. Doesn't one have to consider the spending side as well as the receipt side? Thus, Government collects taxes from some and dispenses funds to others. If it collects taxes normally but doesn't dispense the funds normally, the accumulation of a larger balance is surely a factor on the deflationary side. To some extent at least, this certainly occurred in the second quarter of this year when the fiscal position of the cash budget, seasonally adjusted, shifted from a significant deficit to near balance.

Another point of possible disagreement with the Sternlight memorandum stems from his discussion of the significance of a Government balance built up through borrowing from the private nonbank sectors of the economy. Here he suggests that if this nonbank borrowing is done through

short-term securities, the deflationary effect on the economy is minimal. But even here there is surely some dampening liquidity effect merely from the fact that the public has traded very liquid cash for less liquid securities, unless one assumes that if the securities had not been purchased, the money would have been held as idle cash balances.

Moreover, one must be very careful here to avoid double counting. If it is relevant to take into account the effects of the increase in Government balances in building up the nonbank public's holdings of short-term Government securities, should we at the same time add into the money supply (or the reserves available to support it) any part of the idle Treasury balances generated in the process of putting these securities in the hands of the public?

It is generally accepted, moreover, that in order to get the community to hold more short-term Government securities rather than cash, higher interest rates have to be paid. These higher rates on short-term Government issues necessarily get reflected in higher short-term private rates. In addition, they make lenders somewhat more willing to hold short-term rather than longer term securities. As a result, longer term interest rates and presumably capital investment are also affected adversely to some extent.

As for the relevance of all this to the present situation, one can only say that <u>part</u> of the Government's current large balance has been built up as a result of borrowing from the nonbank public. The rest apparently came mainly from tax receipts in excess of expenditures, for bank holdings of Government securities were virtually unchanged on balance over the period of the buildup. From the end of April to the end of August

(latest data available for nonbank holdings of Governments), the Government's cash balance rose almost $3 billion whereas nonbank holdings of Government securities rose about $1-1/4 billion. Nonbank holdings of Governments with maturities of a year or less, however, rose about $2-1/2 billion, indicating some shortening on balance of Government portfolios. In September, Government deposits rose another half billion or so, and nonbank holdings of short-term Governments must have decreased appreciably as a result of the advance refunding, even allowing for the fact that most of the longer issues offered in the refunding were taken by commercial banks.

A fact not to be overlooked is that the current larger Government balance was built up in order to maintain higher short-term interest rates, at least at levels higher than market flows of funds would have produced recently. One danger in the attempt to maintain short rates through debt management policy is that the effort will contribute to an undesirable circular process wherein a sluggish economy generates liquidity, which tends to depress short rates, which in turn requires more Government borrowing and higher cash balances to offset. If, under these circumstances, the Federal Reserve authorities were to consider Government deposits as part of the money supply, it would mean a further dampener to private deposit expansion.

This is not to deny that a larger question is involved here, namely, assuming the desirability of firm short-term interest rates, what are the relative roles of debt management policy and monetary policy in helping to achieve such an objective? What, for example, would have been the posture of monetary policy in recent months if it had provided the

added firming influence on short rates that was in fact provided by Treasury advance borrowing and the resultant larger than normal cash balances?

My conclusion is that the recent buildup of the Government balances has been a deflationary influence. At the same time I do not argue that it has necessarily been a powerful one--judgments will differ on that. If some part of the recent increase in Government deposits should be counted as an effective increase in the money supply, Sternlight's estimate is probably too high. While it may be a mistake not to count some of it as money supply, it would be a mistake to count that much. My own view is that no adjustment gives a closer approximation than one as large, or nearly as large, as 50 per cent, if one is trying to assess (1) the effect of the increased Government balances on private liquidity and incomes, and (2) the influence of recent monetary policy on total economic activity.