BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON

May 12, 1960.

CONFIDENTIAL (FR)

TO: Federal Open Market Committee

FROM: Mr. Young

At Chairman Martin's suggestion, the enclosed memorandum dated April 20, 1960, prepared by Mr. Knipe on the "Non-Borrowed Reserves" Concept is being sent to you for your information.

Ralph A. Young

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

Enclosure

Wednesday
April 20, 1960

To: Chairman Martin

From: James L. Knipe

Subject: (1) The "Non-Borrowed Reserves" Concept.

(2) Its usefulness in the first fifteen weeks of Calendar 1960.

In view of the complexities and difficulties inherent in the management of banking reserves, it would seem logical to make their definitions, nomenclature, and arithmetic as simple as possible. For the last seven or eight years I have been using the idea of "Non-Borrowed Reserves" as a starting point for the easiest way to study, and explain, the whole problem of reserves.

"Non-Borrowed Reserves" are, of course, all of the reserves created by the Federal Reserve System without the aid of the member banks as expressed in their borrowing activities. So:

	Non-Borrowed Reserves
minus	Required Reserves
equals	Free Reserves

Within the System, a more complicated definitional tradition has taken root:

	Total Reserves
minus	Required Reserves
equals	Excess Reserves
minus	Borrowings
equals	Free Reserves

Particularly in explaining Free Reserves to untrained outsiders, I think this more complicated approach makes the explanation almost impossible a great deal of the time.

The arithmetic typically looks something like this for the simpler terminology:

	Non-Borrowed Reserves	=	$19.0 billion
minus	Required Reserves	=	$18.5 billion
equals	Free Reserves	=	$ .5 billion

or, if Free Reserves are negative:

	Non-Borrowed Reserves	=	$19.0 billion
minus	Required Reserves	=	$19.5 billion
equals	Free Reserves	=	-$ .5 billion
	(or Negative Free Reserves	=	$ .5 billion)
	(or Net Borrowed Reserves	=	$ .5 billion)

Using the more complicated terminology, the arithmetic looks like this:

	Total Reserves	=	$19.5 billion
minus	Required Reserves	=	$18.5 billion
equals	Excess Reserves	=	$ 1.0 billion
minus	Borrowings	=	$ .5 billion
equals	Free Reserves	=	$ .5 billion

and similarly for the Negative Free Reserve computation.

Of course, the simpler method would not save any time or computation if it were necessary to bring in the concepts of Total Reserves, Borrowings, and Excess Reserves <u>every</u> time the subject of reserves comes up. I do not think it is necessary to do so, and I always find it enlightening to contemplate, <u>first</u> of all, the <u>most basic</u> of the relationships, that between Non-Borrowed Reserves and Required Reserves, the difference between which is called Free Reserves.

Non-Borrowed Reserves is the volume of reserves freely made available by the System. I like to regard the charted curve of Non-Borrowed Reserves as a roof which sets a limit to the money-creating activities of the member banks. Free Reserves are represented by the space remaining available just underneath that "roof" above the Required Reserves line. Negative Free Reserves are represented by the distance above the old roof level as seen when the member banks choose to lift the roof temporarily higher by borrowing. But borrowing requires decisions and actions on the part of the member banks, and they are under more or less constant pressure of some kind or another to reverse their actions, to pay off their borrowings, and let the roof sink back to somewhere near where the System had placed it.

The most obvious weakness of concentration on the Free Reserve (or Negative Free Reserve) figure as an objective is that while it is usually a suitable figure for three weeks, it may be a dangerously misleading figure if the Committee lets itself slide unconsciously into the habit of using it over and over again, so that it tends to become a longer-range objective. In other words, it is dangerous to use it unless one assumes that Required Reserves are remaining substantially unchanged. If Required Reserves are moving upward, an unchanged Free Reserve objective will tend to finance an inflation; if Required Reserves are going downward, an unchanged Free Reserve objective will tend to push banks down into reserve deflation.

Therefore, it is my feeling that the Free Reserve (or Negative Free Reserve) instruction to the Account Manager should be frequently reviewed with respect to what is happening to (1) Non-Borrowed Reserves, and (2) Total Reserves and Borrowing. This is undoubtedly done, and has been done right along, but I am not sure that it has been simply described or adequately emphasized.

A good example of this inadequate emphasis is, I believe, illustrated in the events of recent months. Free Reserves, when looked at in tabular form, convey a general feeling of easing in the first fifteen weeks of Calendar 1960:

Free Reserves - 1960 to date
(In millions of dollars)(Averages of daily figures)

Week Number	Week Ending	Free Reserves	Change	Cumulative Change
1.	Jan. 6	(468)		
2.	Jan. 13	(354)	+ 114	+ 114
3.	Jan. 20	(319)	+ 35	+ 149
4.	Jan. 27	(371)	- 52	+ 97
5.	Feb. 3	(327)	+ 44	+ 141
6.	Feb. 10	(418)	- 91	+ 50
7.	Feb. 17	(465)	- 47	+ 3
8.	Feb. 24	(195)	+ 270	+ 273
9.	Mar. 2	(352)	- 157	+ 116
10.	Mar. 9	(230)	+ 122	+ 238
11.	Mar. 16	(215)	+ 15	+ 253
12.	Mar. 23	(134)	+ 81	+ 334
13.	Mar. 30	(244)	- 110	+ 224
14.	Apr. 6	(290)	- 46	+ 178
15.	Apr. 13	(168)	+ 122	+ 300

The picture is quite different when Non-Borrowed Reserves are tabulated. The "roof" was lowered steadily on the banking systems throughout the period;

Non-Borrowed Reserves

(In millions of dollars)(Averages of daily figures)

Week Number	Week Ending	Non-Borrowed Reserves	Change	Cumulative Change
1.	Jan. 6	18,147		
2.	Jan. 13	18,117	- 30	- 30
3.	Jan. 20	18,009	- 108	- 138
4.	Jan. 27	17,658	- 351	- 489
5.	Feb. 3	17,679	+ 21	- 468
6.	Feb. 10	17,429	- 250	- 718
7.	Feb. 17	17,246	- 183	- 901
8.	Feb. 24	17,428	+ 182	- 719
9.	Mar. 2	17,242	- 186	- 905
10.	Mar. 9	17,356	+ 114	- 791
11.	Mar. 16	17,348	- 8	- 799
12.	Mar. 23	17,582	+ 234	- 565
13.	Mar. 30	17,248	- 334	- 899
14.	Apr. 6	17,186	- 62	- 961
15.	Apr. 13	17,203	+ 17	- 944

This deflationary action came about as a result of continued instructions to the Account Manager couched in terms of Free Reserves. Presumably the rationale on which it was based was that the downward movement of Required Reserves, which the Non-Borrowed Reserves followed, was essentially a seasonal matter. The facts would seem to be--subject to much more detailed analysis--that the decline in Required Reserves, shown below, was considerably greater than seasonal and that the decline also went beyond the usual seasonal in time duration.

Required Reserves

(In millions of dollars) (Averages of daily figures)

Week Number	Week Ending	Required Reserves	Change	Cumulative Change
1.	Jan. 6	18,615		
2.	Jan. 13	18,445	- 170	- 170
3.	Jan. 20	18,385	- 60	- 230
4.	Jan. 27	18,138	- 247	- 477
5.	Feb. 3	18,106	- 32	- 509
6.	Feb. 10	17,866	- 240	- 749
7.	Feb. 17	17,779	- 87	- 836
8.	Feb. 24	17,655	- 124	- 960
9.	Mar. 2	17,696	+ 41	- 919
10.	Mar. 9	17,575	- 121	- 1,040
11.	Mar. 16	17,588	+ 13	- 1,027
12.	Mar. 23	17,730	+ 142	- 885
13.	Mar. 30	17,559	- 171	- 1,056
14.	Apr. 6	17,476	- 83	- 1,139
15.	Apr. 13	17,371	- 105	- 1,244

The deflationary movement is shown below, even more emphatically in Total Reserves, because the member banks concurrently reduced their borrowing. In this case, therefore, the Total Reserve table exposes what needs to be exposed more effectively than the Non-Borrowed Reserves table. If, however, member banks had concurrently increased their borrowing, the situation would have been more effectively exposed by the Non-Borrowed Reserves table.

Total Reserves

(In millions of dollars) (Averages of daily figures)

Week Number	Week Ending	Required Reserves	Change	Cumulative Change
1.	Jan. 6	19,160		
2.	Jan. 13	19,028	- 132	- 132
3.	Jan. 20	18,923	- 105	- 237
4.	Jan. 27	18,431	- 492	- 729
5.	Feb. 3	18,487	+ 56	- 673
6.	Feb. 10	18,279	- 208	- 881
7.	Feb. 17	18,219	- 60	- 941
8.	Feb. 24	18,048	- 171	- 1,112
9.	Mar. 2	18,035	- 13	- 1,125
10.	Mar. 9	17,951	- 84	- 1,209
11.	Mar. 16	18,074	+ 123	- 1,086
12.	Mar. 23	18,169	+ 95	- 991
13.	Mar. 30	17,850	- 319	- 1,310
14.	Apr. 6	17,890	+ 40	- 1,270
15.	Apr. 13	17,874	- 16	- 1,286

Whether one takes the decline in Total Reserves of $1,286 million, or the decline in Non-Borrowed Reserves of $944 million (the difference of $342 million is accounted for by reduction of Borrowings in that amount), there is an indication of something which looks deflationary, a downward movement of a size and duration which might lead to serious concern about the state of the economy.

A preliminary examination of the bank asset totals and subtotals for Weekly Reporting Member Banks does not reveal any obvious weakness. The asset liquidation by the banks took place almost entirely in holdings of Government securities, in loans on Government securities, and in loans on other securities. Business loans actually had what would appear to be a small counterseasonal growth during this period. However, a liquidation of this magnitude and duration deserves a great deal of detailed study and, in the meantime, suggests a somewhat easier policy as an elementary precautionary measure.

A number of suggestions have recently been advanced relative to secular criteria in the form of Total Reserve levels as policy objectives. My views stop somewhat short of reliance on any such measures as specific objectives at any moment of time, but are in agreement that frequent reference should be made to the levels and movements of Total Reserves and, as an often more useful figure, to the levels and movements of Non-Borrowed Reserves.

I suggest, therefore, that Non-Borrowed Reserves be presented regularly in tabular and charted form, and that policy be appraised frequently against the background of the levels and movements of Non-Borrowed Reserves as well as of Total Reserves.