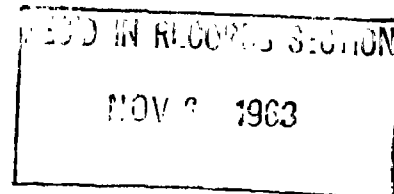


November 4, 1963

To: FOMC Staff Economists

Subject: Reserve Guideline

From: Albert R. Koch



At the last meeting of the Federal Open Market Committee, Presidents Bryan and Hickman raised two issues about the required reserve guideline computations presented every three weeks in the staff reserve memorandum. One issue concerned the advisability of shifting the base period after each significant change in policy, thereby eliminating in each instance the accumulated excess or deficit. The second concerned the advisability of continuing to use a 3 per cent annual growth rate in the computations.

The fact that these questions were raised concerning the present guideline computations suggests that a review of present guideline procedures is in order. This review, in addition to concerning itself with the issues raised by Presidents Bryan and Hickman, might well also include discussion of certain other issues concerning the present computations that have been raised from time to time. Among these are: (1) the present implicit relative weights given to demand and time deposits in the single required reserve figure; (2) the present procedure of subtracting from reserves those required behind Government deposits in calculating the guideline; and (3) the value of any guideline at all for required reserves behind private deposits, or for that matter for any total reserve concept.

In the case of all of these issues, there are no solutions that contain all advantages and no disadvantages. The task is rather that of

choosing the particular guideline computations that are most likely to illuminate and least likely to mislead one who is involved in making a judgment as to the appropriateness or inappropriateness of current monetary policy.

The Base Period

The decision to adopt the present procedure of reverting to a zero base period after each significant change in monetary policy was first made at the time of the December 1961 policy change and has been followed with respect to each of the subsequent four policy changes as well. As is shown in the following table, on four occasions the result was to cancel out an overage and in one case, in June 1962, an underage was erased.

Policy period	Annual rates of expansion 1/		Excess (+) or shortfall (-) of actual compared with projected required reserves
	Assumed	Actual	
	(Per cent)		(Millions)
Mar. 1 - Nov. 29, 1961	5	5.1	+53
Nov. 29, 1961 - June 13, 1962	4	2.8	-95
June 13 - Dec. 19, 1962	3	4.2	+129
Dec. 19, 1962 - May 22, 1963	3	3.2	+39
May 22 - July 31, 1963	3	4.3	+56

1/ Annual rates of expansion and differences from actual figures based on revised seasonally adjusted deposits data. Projected rates allow for expansion in demand and time deposits only; actual rates include in addition changes in net interbank deposits. Required reserves held against time deposits computed at 5 per cent requirement ratio in the first two periods between March 1, 1961, and June 13, 1962, and at 4 per cent thereafter, to reflect the change in requirements that occurred at the end of October 1962.

This procedure was followed mainly because it was thought that the usefulness of the guideline figure to policy formation would be

maximized if the figures tried to show what effects current policy was having on the current rate of reserve growth. It is also appropriate, of course, for current policy to take into account what has or has not been accomplished as a result of past policies.

Obviously "updating" of the base period at some interval is desirable. Carrying forward surpluses or deficits from remote past periods would not only reduce the usefulness of the guideline, it might be actually misleading with respect to the impact of current policy on reserve growth. As I understand President Bryan's comment, he does not feel that the current procedure regarding the base period adequately handles the balancing of past and current contributions to the reserve base.^{1/}

Growth Allowance

A growth allowance of some dimension has been included in the staff reserve projections since early 1961. At first, as the table shows, the allowance was at an annual rate of 5 per cent, but it was cut to 4 per cent at the end of 1961 and to 3 per cent in mid-1962.

These procedures have been used essentially for the following reasons. Some growth allowance was felt to be a desirable addition in projections in order to avoid overlooking the need, over time, to provide for expanding monetary needs of a growing economy. The actual amounts involved for growth alone (ranging from \$10 million to \$15 million a week over the past 2-1/2 years) are insignificant in relation to the large reserve fluctuations experienced in any one or a few weeks. But the steady accumulation of the growth allowance over time gradually amounts to a sizable sum.

^{1/} A simple way of handling this problem, for the present at least, might be to add a second guideline computation using a fixed base, say in December 1961, approximately the time at which the current course of gradually lessening ease began.

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The percentage allowance first chosen was set in relation to past and prospective growth patterns of monetary demand within the framework of expected trends in GNP and the flow-of-funds accounts. Thereafter, the usual operating rule, on each occasion when the Committee acted to make monetary policy slightly less easy than it had been, was to reset the projected growth rate below the actual rate that had developed under the preceding policy. This procedure was tempered when the result seemed unreasonable or out of keeping with the expressed wish of the Committee (as it did on one occasion, in mid-1962). Furthermore, the amount of the step-down in rate from the preceding actual rate of growth to the projected one was a matter of judgment, reached in the light of Committee expressions and the apparent sustainability of past and expected patterns of business and financial activity. A particular case in point was the decision to continue to use a 3 per cent growth rate after the July 1963 FOMC action, which itself followed an actual May-July annual growth rate of over 4 per cent.

In this most recent case, it is also of relevance to note that with actual required reserves behind time and savings deposits recently increasing at a seasonally adjusted annual rate of a little over 16 per cent, a 3 per cent increase in required reserves behind total private deposits provided no reserves for expansion of demand deposits. If the 3 per cent figure were to be reduced to 2 per cent, and assuming continuation of the current actual rate of growth of time deposits, a demand deposit contraction at an annual rate of about 1-1/2 per cent would be implied. Although it is true that some of the recent growth in time and savings deposits has no doubt reflected a shift out of relatively inactive demand

deposits which, in other interest rate contexts, might well have remained as temporarily idle demand deposits, the staff did not consider it appropriate to use a guideline figure that implied actual demand deposit contraction.^{1/}

Time Deposits

What, if any, allowance in the guideline computation should be made for required reserves behind time and savings deposits? As mentioned earlier, the present computations give an implicit weight to time deposits of approximately one-fourth that given to demand deposits. This is in a sense an accidental weight, but if it had not seemed reasonable or if there had been evidence to support an alternative, it would not have been adopted. The weighting depends mainly on the different reserve requirement percentages behind time and demand deposits but also to a lesser extent on the difference in the outstanding volume of time and demand deposits which currently is quite small.

Government Deposits

There is also the question as to the most meaningful procedure for allowing for required reserves behind Government deposits. The current guideline includes reserves required to cover seasonal changes and growth in private deposits plus reserves for whatever growth in Government deposits occurs, or less any reserves that are released by Government deposit

^{1/} A simple way of partially handling this problem in the first chart used in the staff memorandum would be to again add a "fan" of alternative growth lines. At one time this fan embraced growth lines of from -3 to +3 per cent. With respect to the guideline statistic embodied in Table 1 of the memorandum, the growth allowance (whether 3 per cent or any other figure) could be dropped, and only the actual rate of change from the base period reported.

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decreases. The essential reason for adopting this procedure was to conform to a private money supply concept, which, in turn, is based on the thought that private spending is affected by the size of cash balances but Government spending is not. In other words, under the present procedure Government fiscal, budget and debt management policies are treated as exogenous factors. This means that a decision, in effect, is made as to whether any given change in private deposits, no matter what the sources, is appropriate to the given economic and financial situation both at home and abroad.

The present procedure has, however, caused problems on occasion in the interpretation of deviations of actual required reserves from the guideline projections in the short run, a short run which can run over several weeks or even months. Shortfalls and excesses from the present reserve guidelines have at times been due mainly to shifts in deposits between Government and private hands. The question is whether such shifts significantly affect private decision-making in the short run. The answer probably depends to a large extent on the particular source or disposition of the change in Government deposits, the duration of the change, and on the resulting effects on bank credit availability and interest rates.

Another argument for including reserves required behind Government deposits in any guideline is that these reserves are as much the base for bank credit creation as reserves required behind private deposits. This is true even though some of the Government deposits on occasion prove to be quite temporary, as for example, around financing dates. This argument appeals particularly to those who lay main emphasis on the bank credit

creation, as contrasted to the money creation, aspects of monetary policy.^{1/}

Elimination of the Guideline

The issues raised by the necessary arbitrariness in deciding upon the particular weights for reserves required against demand and time deposits, as well as the difficulty of arriving at the most appropriate treatment for reserves required behind Government deposits, raises the more general question as to whether there should be any guideline at all for reserves required behind total private deposits.

It can be argued that if trends in the total of demand and time deposits cannot be considered independently of trends in each of the two components considered separately, then there is no point in setting a guideline for required reserves against total private deposits. It can also be argued that a guideline computation restricted to the reserve creation aspects of policy can be misleading in that it does not adequately take into account the bank credit creation and interest rate aspects of policy.^{2/}

^{1/} An alternative for handling required reserves behind Government deposits might be to include an assumed volume of such reserves in the guideline computations. In such a case, it might still be appropriate to make special allowance for large temporary swings of Government deposits and the reserves required to support them. Or, alternatively, an allowance might be made in the guideline for required reserves behind private deposits for changes in such deposits that are estimated to have been due to more than seasonal changes in Government deposits

^{2/} One suggestion that has been made is that the guideline computation include, in addition to a separate allowance for growth of demand and time deposits, a third allowance for growth in total bank credit. Offhand, the problem of reconciling what could be conflicting growth objectives for the asset as well as the liability side of the balance sheet of the banking system would seem to be a difficult one.

Concluding Comments

It should be stressed that whatever decision is made on these issues regarding the construction, or for that matter the elimination, of the guideline computations, such computations in and of themselves have no necessary connection with the appropriateness or inappropriateness of any particular monetary policy. If it is felt that recent growth in reserves has been inappropriate, a change in policy is called for, not because of any observed relationship of actual reserve developments to any given guideline, but rather because of a judgment concerning the course of actual reserve developments relative to over-all economic and financial developments, including those in the balance of payments. Perhaps "reference line" is a more appropriate term than "guideline" for these reserve computations and perhaps more than one reference line is called for.

It would, of course, be most useful if there were available and generally accepted one or even a few mutually consistent and specific goals or targets by which to assess the appropriateness or inappropriateness of current monetary policy. But, unfortunately, such is not the case, and it is unlikely that it ever will be. The reserve guideline, no matter how constructed, is only one of a number of statistical indicators to be used in arriving at what in the end must still be essentially a matter of judgment concerning the appropriateness of current policy. Nevertheless, if policy has to be determined in the context of the whole economic situation, any guideline computations, too, should try to embrace the whole rather than one or even a few of its parts.

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FOR FILES
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