B_B93
Reserve Requirements
August 1970

CONFIDENTIAL

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

DATE 8/12/70

TO Chairman Burns

FROM J. CHARLES PARTEE

re: Reserve requirement reduction

Partee strongly supports a reduction

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

SPECIAL

See p 3 —
a r/20 considered
stimulative !

Cut [illegible] —
FF unchanged
[illegible]

p. 5 Conclusion
[illegible]

Considerations Bearing on a Reserve Requirement Reduction.

1. The economy is on dead center. It cannot be said that business activity is either increasing or decreasing at present. The probabilities are for some recovery in the months ahead, ignoring the effects of a likely auto strike, but there is virtually no chance that this would put pressure on resources, given the present level of under-utilization.

2. The resumption of even moderate real growth (3 - 4 percent) depends importantly on a recovery in housing and State-local construction. Business capital spending clearly is on the decline--although there is still no evidence of a precipitate cut-back--and defense spending is scheduled to be falling for some time yet. The availability of funds for both housing and municipal finance has improved considerably, and chances are that an upturn in both types of spending is now under way. Credit terms--both interest rates and conditions of lending--are still tight, however, and lenders are not yet aggressively seeking outlets for funds. Additional stimulus, therefore, would not be unwelcome.

3. Labor market conditions continued to ease into July, and there is not much prospect for improvement--given the probability of only modest real growth in the economy and the cyclical tendency for productivity to gain--in the months

immediately ahead. Indeed, we are projecting a further rise in the unemployment rate, to 5.1 percent in the 3rd quarter and 5.3 percent in the fourth, in the current greenbook. The September-October period may be particularly troublesome, both because there is an observed tendency for unemployment to rise more than allowed for in the seasonal adjustment then and because of the possibility that secondary layoffs will develop in connection with an auto strike. An upsurge in unemployment in the fall months--just before elections--would create strong pressures to do something to reverse the trend, in fiscal or monetary policy or both.

4. Financial market conditions, though somewhat easier, have not moved as quickly in this direction as ordinarily would be indicated by the current and prospective slack in the economy. Thus we have been having trouble keeping the money supply growing at a satisfactory rate, with the current projection for the third quarter appreciably below the 5 percent or more rate of growth envisaged by the FOMC. Moreover, the decline in long-term market rates has stalled recently, partly because of a continued heavy volume of offerings, and the prospects for a resumption of a significant rate decline in the near-term do not seem particularly good. An overt monetary policy action, in the form of a net reduction in reserve requirements, would be helpful in both areas. It would

undoubtedly bring an initial decline in interest rates, as investors anticipated easier monetary conditions, and it would encourage the banks to bid more aggressively for investments, which would tend to increase money balances of the public as securities are sold, net, into the banks.

5. Technical features of the financial markets also suggest the desirability of a restructuring in reserve requirement burden. Banks have increased further their net outstandings of commercial paper in recent weeks, despite freedom to sell short-term CD's, and the total has now reached $7.7 billion. It appears that there is a marginal cost advantage associated with commercial paper, and this is hightened by the reserve requirement differential--6% on CD's and zero on commercial paper--which should be worth on the order of 50 basis points in savings to the paper issuing banks. If the Board wishes to encourage banks to raise funds directly rather than indirectly--which I think is desirable on regulatory and supervisory grounds--then it should move to close this commercial paper cost advantage. The application of equal reserve requirements on both types of instruments clearly is indicated, and there is nothing to be gained by waiting in doing this.

All of the economic and financial market arguments that I can think of thus are on the side of making a cut in reserve requirements, and preferably one that would equalize the requirements on CD's and commercial paper. There is very little risk of overstimulating the economy in doing this, and the action should provide some insurance that financing conditions, particularly with respect to housing and municipal spending, will in fact continue to improve. There are, however, some arguments against a reserve requirement reduction at this time, four of which are outlined below.

1. An overt easing action in the monetary sphere, combined with the public sense of a continuous process of easing in fiscal policy, will tend to heighten the impression that there is an inflationary bias in public policy. There is nothing very specific that can be cited that would happen in the short-run as a result of this feeling, but it would probably tend to weigh marginally on the side of encouraging private expenditures that could not be fully justified on other economic grounds. Over the long-run this could be a considerable factor in stimulating aggregate demands, but of course there would also be many future opportunities to reverse the monetary signals when and if aggregate demand seems to be mounting excessively.

2. An overt action toward ease in monetary policy could be regarded as a submission by the Board to well-advertised pressures from the Administration for increased rates of monetary growth. This could add to the impression of permissiveness cited above, even though a reserve requirement reduction does not necessarily signify a

faster rate of monetary growth. There is no way around this problem that I can see, and my personal view is that such considerations should not prevent us from doing what is right and appropriate on economic grounds.

3. Current labor negotiations in the auto industry conceivably could be influenced marginally by an overt easing in monetary policy. The union might feel that this indicates official concern about the effects of a strike, and the employers might believe that the better markets promised in time by more monetary stimulation would tend to increase their ability to absorb a larger settlement. To conclude that our action could have any appreciable impact takes a very long stretch of the imagination, but I mention it as a possibility because of the great current sensitivity of this particular negotiation.

4. The effect of reducing reserve requirements, other things being equal, is to transfer earnings from the Federal Reserve to the member banks. This follows from the fact that fewer interest-free reserves are required to support any particular level of deposits. Since the Federal Reserve pays all of its net earnings to the Treasury, while banks pay a little less than half, the direct effect of a reserve requirement reduction is

to reduce Treasury revenues. The effect is small--in this case, assuming a 4-1/2 percent requirement on both commercial paper and time deposits, and assuming a 6-1/2 percent interest rate, it would be on the order of $25 million per annum--but it is sometimes commented upon by the Congress. The obvious answer is that the anticipated stimulative economic effects of the action would generate far more in revenue than is forgone directly, but it can still be argued that the same result could be achieved through open market operations which would not involve any revenue loss.

JCP 2/12