STRICTLY CONFIDENTIAL

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RESERVE IN TREASURY BILLS AND CERTIFICATES

Under the policy of the Federal Reserve System of maintaining the present pattern of rates, commercial banks can sell certificates to the Federal Reserve, and commercial banks as a whole can expand credit by several times the amount sold to the Federal Reserve. This will continue until the yields on longer-term securities, both Government and non-Government, and rates on loans have been driven down to the point where commercial banks consider the spread to be unattractive. The only other limit to this expansion is the outstanding amount of bank-eligible Government securities still held by nonbank investors, plus the amount of outstanding non-Government securities that commercial banks are willing and able to buy either from nonbank investors or on issue, plus the amount of loans that banks are willing to make.

Adjustment to security reserve. -- In order to reduce the magnitude of this expansion, it has been proposed that all commercial banks in the country be required to maintain holdings of Treasury bills and certificates at or above some percentage of their net demand deposits. If the percentage were placed sufficiently high, commercial banks would find it necessary to purchase bills and certificates in order to meet the requirement, and unless the Federal Reserve supplied reserves freely commercial banks would find it necessary to sell notes and bonds. This would reduce commercial bank earnings.

In addition, sales of notes and bonds by commercial banks would remove the pressure for yields on these securities to decline. The Federal Reserve might not support the prices of notes and bonds, except to the extent necessary to maintain an orderly market, until the latest issue of 2 1/2s declined practically to par. The price of this issue then would be prevented from declining further by Federal Reserve purchases of whatever amount was necessary. The Federal Reserve also would maintain the yields on certificates at present levels by purchasing or selling whatever amounts were necessary.

The crucial point, however, is that it would be necessary to permit the yields on issues with maturities between certificates and the latest issue of 2 1/2s to fluctuate according to demand and supply in the market. The Federal Reserve would purchase or sell these issues only to the extent that it was necessary to maintain an orderly market or to the extent that it was desirable to increase or decrease reserve balances. The effect of the proposal on the level of bank credit would depend largely on the extent to which the yields on these securities would be permitted to fluctuate. The yields on these securities would be of no concern to the Treasury, because under this proposal new issues would be confined to bills, certificates, and long-term bonds.

The following illustration, which is based on figures for June 30, 1945, the latest date for which complete information is available, shows the effects of the plan under two levels of certificate requirements. The first level, 36 per cent, would keep total commercial bank holdings of reserve securities at about the present level, but would enable large sales by reserve city banks and would necessitate large purchases by New York City Banks. The commercial banks that needed to purchase reserve securities would purchase them from the Federal Reserve, other commercial banks, and nonbank investors, and sell a corresponding amount of non-reserve securities to the same groups. The banks that held an excess of reserve securities could sell the excess or part of the excess to the three groups and purchase a corresponding amount of non-reserve securities from these groups. The net effect on total bank credit would depend upon whether or not there was any net change in reserve balances, and the Federal Reserve presumably would adjust its buying and selling prices so that reserve balances would change only by the amount desired. The second level, 53 per cent, would require commercial banks to purchase practically all of the reserve securities now held by nonbank investors and presumably to sell to nonbank investors a corresponding amount of non-reserve securities. Again, the net effect would depend upon whether or not there was any change in reserve balances.

Item	Net demand deposits	War loan deposits	Bills, certificates and .90s	36 per cent requirement		53 per cent requirement	
				Actual	Change	Actual	Change
	(In billions of dollars)						
New York City	18.9	7.6	5.1	6.8	+1.7	10.0	+ 4.9
Chicago	4.2	1.5	1.7	1.5	- .2	2.2	+ .5
Reserve city	24.4	7.6	10.4	8.8	-1.6	12.9	+ 2.6
Country	17.7	5.1	6.3	6.4	+ .1	9.4	+ 3.1
Insured non-member	1/ 7.0	1.5	2.3	2.5	+ .2	3.7	+ 1.4
Non-insured non-member	1/ 1.3	--	.4	.5	--	.7	+ .2
Total commercial banks	73.3	23.2	26.2	26.4	+ .2	38.9	+12.7
Federal Reserve Banks	--	--	20.0				
Nonbanks	--	--	13.3				
Total			59.5				

1/ Excluding due from banks estimated to be required reserves.

Subsequent effects. -- Under the proposed system expansion of bank credit could continue, unless all reserve securities were in the hands of the banking system and the Treasury issued no more. More importantly, bank credit expansion would be limited by the fact that the Federal Reserve would be free to allow yields between the yields on certificates and the yield on the new 2 1/2s to fluctuate. If the Federal Reserve were free to vary the yields on such securities, reserve balances could be maintained at a desirable level unless nonbank sales were depressing the price of the new 2 1/2s below par.

Expansion of bank credit could occur in a number of different ways. First, commercial banks would be able to increase their earnings by selling notes and bonds that mature within five years and buying longer- term bonds. The expansion in bank credit would be similar to the present expansion if they sold the notes and short-term bonds to the Federal Reserve and bought the longer-term bonds from nonbank investors, except for the fact that any expansion in bank credit would be limited by the increased requirement for holding reserve securities and the banks' ability to obtain such securities. The Federal Reserve could stop this type of expansion by permitting the prices of notes and short-term bonds to decline until an equilibrium point was reached in the rate structure. This equilibrium point would be reached sooner than would be the case under present policies, because there would be a smaller amount of short-term securities involved in commercial bank sales and also because the differential in yields would be smaller.

Second, commercial banks could expand credit if commercial banks losing reserves sold Government securities to the Federal Reserve. These sales would consist partly of reserve securities and partly of non-reserve securities.

This would increase reserve balances. Commercial banks receiving reserves from this source, from gold imports, or from a decline in currency in circulation and banks using their already existing excess reserves would be able to expand bank credit by purchasing Government securities amounting to several times the increase in their reserves. The only limitation on their purchases that is not now present would be that part of their purchases would need to consist of reserve securities.

Third, expansion could take place if nonbank investors sold from their holdings. This would occur if the new 2 1/2s reached par and nonbank investors still wanted to sell, because in that event the Federal Reserve would need to purchase these securities. The resulting increase in reserve balances would permit an expansion of bank credit.

Fourth, if the Treasury continues to follow the practice of refunding all called and maturing issues into certificates, bank credit will continue to increase, because nonbank investors would continue to sell from their existing holdings and also because the supply of reserve securities would be increased. It would be preferable to design the refunding policy so as to attract the investment of nonbank funds. Bank holdings, however, could be refunded into reserve securities. The effect of the resulting increase in the supply of reserve securities could be offset by increasing security requirements.

On the other hand, one factor that will encourage contraction of bank credit is the gradual shift of deposits from war loan to other accounts. Under either the present system or the proposed system, this will absorb reserves, and banks will be able to maintain their present holdings only if the Federal Reserve is willing to purchase the necessary amount of securities.

General considerations. -- This requirement to be effective should be made applicable to all commercial banks. This presents a problem with respect to non-member banks, since their reserve requirements differ from those of member banks and since their reserves consist in considerable part of balances with member banks.

One variation of the proposal would be to have a total requirement equal to present reserve requirements on net demand deposits plus the security reserve. Of the total requirement at least the present reserve requirement would need to be in reserve balances. The remainder could consist of either reserve securities or excess reserves. This would provide some flexibility to commercial banks that were gaining deposits and did not have adequate reserve securities on hand. Also, if the supply of reserve securities were limited, this device would serve as a check on further credit expansion.

This proposal would require legislation, which might take a year. Since the time element is important, in view of both the current market and the current inflationary situation, this might be too late to be effective. Before the legislation could be passed, it might be desirable to bring about some such a condition in bank portfolios by action by bank supervisory agencies. If this were done examiners would be given this requirement as one of their yardsticks in measuring sound banking practices, and public statements regarding this standard would need to be made by supervisory authorities.

Finally, some provision might be necessary to take care of banks that hold a small amount of Government securities. In the event that total holdings are less than the reserve security requirement, individual banks for a time might be exempted from the requirement provided that all of their Government security holdings were in reserve securities and provided further that they made no increase in their loans or their holdings of other securities.