February 3, 1947

To: Chairman Eccles

From: Woodlief Thomas

Attached is a copy of a report "Analysis of Credit Control Proposals" prepared by the Committee on Banking and Credit Policy and submitted to the System Research Advisory Committee and to the Subcommittee of the Presidents' Conference Committee on Research and Statistics. These committees in a joint meeting January 21-23 accepted this report and authorized its submission to the Board and to the Presidents' Conference.

This report you will note presents an analysis of the various credit control proposals in the light of current developments and discusses various criticisms of the proposals but makes no attempt to present recommendations. The committee's aim was to provide background material that might be useful to the System authorities in further consideration of the problem.

W.T.

CONFIDENTIAL

January 21, 1947

REPORT TO SYSTEM RESEARCH ADVISORY COMMITTEE AND
SUBCOMMITTEE OF PRESIDENTS CONFERENCE COMMITTEE ON RESEARCH AND STATISTICS

ANALYSIS OF CREDIT CONTROL PROPOSALS
Report of the Committee on Banking and Credit Policy

This is a staff memorandum and its purpose is not to recommend policies to be adopted by the System authorities, but to analyze various credit control proposals in the light of current monetary and fiscal developments. It is designed: (a) to give the background of earlier consideration of credit controls and subsequent suggestions for dealing with monetary problems; (b) to indicate in general terms the effectiveness of existing powers and instruments available to the Reserve authorities; and (c) to analyze supplementary or alternative proposals that have been made. The Committee's aim is to provide the System authorities with a comprehensive summary of the steps developed and thus to give perspective to the further consideration of the problem.

Development of Proposals for Monetary Control

Committee Report of January 1946

In January 1946 the Committee on Banking and Credit Policy submitted to the System Research Advisory Committee a report entitled "Monetary and Fiscal Policies toward Economic Stability". After discussion by the latter Committee, the report was revised and submitted to the Board of Governors and to the Presidents of the Federal Reserve Banks. The report reviewed the policies followed by the System in supporting the financing of the war, and discussed the inflationary pressures then prevailing as an outgrowth of the war and the danger that continuation of wartime monetary policies would contribute further to inflationary tendencies.

It pointed to the fact that under existing System policies the banks could obtain easily and cheaply all of the reserves they wanted to provide the basis for further credit expansion, and to the danger that the banks might take advantage of this situation to make further large purchases of unrestricted issues of Treasury notes and bonds from nonbank investors. It suggested that monetary policies should be directed toward preventing further expansion of bank credit, and, together with fiscal policy, toward curtailing the existing money supply to the extent that was feasible.

The report then discussed various ways in which credit expansion might be limited, first, under the general heading of the use of existing powers, and, second, through supplementary or alternative methods. It pointed out that the System had adequate power to check or discourage further credit expansion by the use of its existing powers and instruments, in view of its huge portfolio of Government securities which would enable it to apply pressure on the banks' reserves and to offset any additions to bank reserves from sources such as gold inflows and return of currency from circulation. It recognized, however, that an obstacle to aggressive use of existing powers and instruments was the probable effects on the management of the public debt -- the danger that the resulting rise in interest rates might affect the market values of outstanding securities, increase the interest charge on the public debt, and create uncertainties concerning refunding operations. The report expressed the belief, however, that three specific steps might be taken in the use of existing powers and instruments without causing significant increases in the interest cost on the debt within the near future:

(a) Eliminate the preferential discount rate;

(b) Eliminate the buying rate for Treasury bills or increase it to a point where it would be in contact with the market; and

(c) Permit the rate on Treasury certificates to rise to a level at which banks would no longer shift from certificates to longer term issues,

It was pointed out that such a policy would have to be effected gradually, and should be accompanied by such support of the long term market as might be needed to keep prices from falling below par. The opinion was expressed that probably very little restrictive action would be needed at first; that the creation of some uncertainty as to the presumed rigidity of the existing pattern of rates might in itself be sufficient to check the strong rise in prices of Government bonds which was then taking place.

The Committee felt that these uses of existing powers should introduce enough uncertainty into the market to check the decline in long term interest rates and to slacken the rate of deposit expansion. It recognized the possibility, however, that over a longer period the remaining differential between long term and short term interest rates might still be great enough to encourage a renewed drift of banks into longer term Government obligations, accompanied by sales of short term securities to the Reserve System and consequent expansion of reserve balances and of bank deposits. It suggested, therefore, that plans should be prepared to meet this possible eventuality, and suggested that the objective of such plans should be primarily to reenforce the "traditional" instruments of credit control and at the same time to prevent an undue increase in the cost of carrying the public debt and in bank earnings from Government securities. The principal plan that was discussed at the time was a requirement that banks hold specified amounts either of Treasury bills and certificates or of special nonmarketable certificates. It was felt, however, that any such plan would require further study, as none had been adequately tested.

Annual Report of the Board for 1945

After further study of such "supplemental or alternative methods" by the Board's staff, the Board of Governors presented for the consideration of Congress in its Annual Report three proposals:

1. That a limitation be placed on the amounts of long-term securities (Government and nongovernment) which commercial banks would be permitted to hold against demand deposits;

2. That commercial banks be required to maintain secondary reserves in the form of Treasury bills and certificates in addition to their primary reserves; and

3. That the Board be given increased authority to raise (primary) reserve requirements, within some specified limit, against net demand deposits.

It was proposed that the Board of Governors be given authority to apply any such proposals to all commercial banks, and that some administrative flexibility be authorized in connection with the application of either of the first two proposals.

Subsequent developments

Within a few months, the first step recommended in the report of the Committee on Banking and Credit Policy -- the elimination of the preferential discount rate -- was taken. The second step -- elimination or lifting of the Treasury bill rate -- has been frequently discussed but no action has been taken to date. The Board has expressed its view that the third step proposed -- namely, to permit the rate on Treasury certificates to rise -- was inadvisable in view of the possible repercussions on the Government securities market and that it would be ineffective in dealing with the inflationary situation.

The action of the System in eliminating the preferential discount rate apparently had effects of more consequence than forcing a limited number of member banks either to pay a higher rate on their borrowings from the Reserve Banks, or to dispose of enough earning assets to repay their indebtedness. It apparently was interpreted as a clear indication that the Reserve System was opposed to a further decline in interest rates.

Even before the preferential discount rate was eliminated, new factors had entered into the situation which helped to check, or even to reverse the tendency toward lower long-term interest rates and toward further expansion of bank credit through bank purchases of eligible Treasury bonds from nonbank investors. Probably the most important was the beginning of the Treasury's debt retirement program, which was started on March 1 and was continued through the remainder of 1946. Another was the rather sudden development of fear that heavy liquidation of speculative holdings of long-term Government securities would occur in May or June, when bank loans to subscribers in the Victory Loan drive would have run for six months and would, therefore, be expected to be repaid.

The debt retirement program exerted recurrent pressure on the reserve positions of member banks during the last ten months of 1946, as it involved withdrawals of funds from the banks to redeem securities held by the Federal Reserve Banks. This forced member banks to part with securities, in addition to those redeemed by the Treasury, in order to restore their reserve positions. Liquidation of loans on Government securities and sales of the securities did not develop in May and June on the scale that was feared, but occurred gradually over a number of months and exerted a moderate restraining influence on the market.

Other factors tending to produce somewhat firmer money market conditions and to restrain any renewed tendencies toward rapidly rising prices for long-term Government securities were the increasing private demands for bank credit and the Treasury program of selling marketable Government securities from the Government life insurance fund on a sizable scale -- the sales amounting in the aggregate to more than 500 million dollars.

The combined result of these factors was a dampening effect on the Government security market which extended over a number of months. Prices of long-term Treasury bonds have shown renewed strength from time to time, but the movement never went far, and in each case was followed by a recession. While the banks have continued to buy some medium-term eligible bonds from nonbank investors in an effort to offset the effect on their earnings of the loss of income from redeemed securities, there have been no strong or persistent tendencies to shift from short-term to longer-term securities, such as were in evidence early in the year and threatened to assume large proportions.

The chief source of further growth in the money supply in recent months has been loans to private borrowers, rather than further monetization of the public debt. The growth in commercial loans, real estate loans, and consumer loans was more than offset during the first half of 1946 by repayments of loans on Government and other securities, but in the latter half of the year there was a fairly sizable net increase in the total volume of loans. Thus the chief source of concern with respect to further growth in bank credit and the money supply became expansion of bank loans, rather than the danger of continued monetization of the public debt, which was the center of the problem at the time the Board's Annual Report for 1945 was being prepared.

During the past few months, however, uncertainty with respect to business prospects for 1947 and rather common fears of some recession later in the year have had a dampening influence on speculative activities, not only in the security markets, but also in the real estate and commodity markets. The prevailing opinion at the present time seems to be that no further sizable expansion in the volume of bank credit is in prospect for the coming months, at least barring further large wage and price increases.

During the first quarter of 1947, it is expected that net Treasury receipts, from an excess of tax collections over Government expenditures, will take a sizable amount of funds from the banks, and even if the proposed debt retirement operations are carried out, not all of the funds will be returned to the banks because of the System's large holdings of the securities to be redeemed. In any case, the Government will take more funds from the public than will be returned to the public, so that some deflationary influence of fiscal operations may be expected. For the moment, therefore, there is no clear evidence of a need for further restrictive measures by the System, although there is still the problem of developing a program that will permit future effective control by the System over the volume of credit in use.

Because of the large money supply outstanding and the potential for further credit expansion, the monetary and credit situation can be an unstabilizing element in the economy for many years. It is therefore important for the System to crystalize its thinking with respect to the best possible uses of its existing powers, and with respect to the question of whether new powers or instruments are or may be needed and whether any of the new instruments that have been proposed to date could be expected to work more satisfactorily than those now available, or to provide valuable and practicable supplements to existing instruments.

Existing Powers and Instruments

Before pressing Congress for the grant of new authority, the System should satisfy itself and be prepared to demonstrate to the satisfaction of others the impracticability or futility of undertaking to use its present powers in the existing circumstances and those that are likely to prevail in the foreseeable future. The first logical step in the consideration of credit control proposals, therefore, is to review again the existing credit control instruments, the uses of them that might be feasible in existing or prospective circumstances, and the considerations in favor of, or against such uses.

Selective credit control instruments

While the main problem before the System is that of checking further growth in the money supply and preventing, as far as possible, unnecessary credit expansion generally, selective credit controls are important because they affect strategic segments of the economy. Flexibly administered, they can be helpful supplementary instruments in general credit policy. Consideration of them, therefore, should be included in a general review of credit control policy.

The recent reduction in margin requirements under Regulations T and U has removed the absolute prohibition on loans for the purpose of carrying listed securities and can be justified in view of the clear evidence of a dampening of speculative tendencies and uncertainty with regard to the economic outlook. Use of this instrument will need to be adapted from time to time to the needs of the economic situation because it affects the environment for financing of capital investments. In this area it may also be desirable to give consideration to the volume of trading in unlisted securities and its relation to bank credit.

As for consumer credit control, the outlook for continuation of the Board's authority to regulate such credit is uncertain in view of the temporary character of the Board's present authority and the strong opposition from certain interested quarters to indefinite extension of that authority. If the System is to be given continuing authority to regulate consumer credit it is clear that the authority should be administered in such a way as to give convincing evidence that the System is alert to changing conditions and capable of prompt action in adjusting the terms of the regulation to changes in business conditions and outlook. Maintenance of present restrictions, after supplies of goods usually financed largely by consumer credit have increased substantially and demand at current prices has slackened, would almost certainly bring upon the System the blame for any recession in the production of such goods, and would greatly reduce the likelihood of a continuing grant of authority to administer such control. It is hardly likely that that situation will be reached simultaneously in all affected lines, and flexibility in the administration of the regulation is highly desirable.

General or quantitative credit controls

The instruments now available under this heading are discount rates, open market operations, and the authority to change the reserve requirements of member banks. As the situation now stands, the only restrictive action that could be taken with respect to reserve requirements would be to increase the reserve required against demand deposits for central reserve city banks from the present figure of 20 per cent up to a maximum of 26 per cent. In view of the fact that there has been no material change from the situation which prevailed when the required reserves of central reserve city banks were lowered, it is not clear that such action would be justified under present conditions. The reserve position of the central reserve city banks still continues to be tighter, on the whole, than that of other groups of member banks. Credit expansion at these banks has been less rapid than at other groups of member banks, and there still is some tendency for New York central reserve city banks, at least, to lose funds on balance to banks in other areas. If this tendency is reversed and funds move to the central money markets in large amounts, then consideration could be given to raising central reserve city requirements.

As for discount rates, the experience with the preferential discount rate -- both with its establishment and with its abolition -- suggests that the discount rate instrument should not be considered obsolete. In fact, the discount mechanism can still function to deter unnecessary credit expansion. Nevertheless, as long as short-term rates are pegged and the System has no option but to supply Federal Reserve credit through purchases of short-term Government securities to the extent necessary to prevent a rise in rates, an advance in discount rates would be of limited effectiveness. Such action would be more likely to accentuate sales of short-term Government securities to the Reserve Banks than to restrain expansion of bank credit.

This leaves as the principal field for possible further steps in a restrictive policy, changes in open market operations, although conceivably at some point such changes might be supplemented by discount rate changes.

In its report a year ago, the Committee on Banking and Credit Policy suggested consideration of action to eliminate the buying rate on Treasury bills and to permit some flexibility in adjusting the pattern of rates to current money market conditions.

As was pointed out previously, the question of the buying rate for Treasury bills has been under discussion for some time, but no action has yet been taken. There appears, however, to be no fundamental disagreement within the System as to the desirability of ultimate elimination of this arrangement. The matter of action is currently receiving study.

As for the proposed change in open market policy with respect to the maintenance of the certificate rate, there seems to be general agreement that the System cannot withdraw suddenly from this market. The public debt is now so large (far overshadowing the aggregate of private debt) and transactions are so large, single offerings frequently running to many millions of dollars, that no one in the System would favor leaving the market to its own devices and running the risk of acute disturbances, with possible wide repercussions. The advocates of flexibility in the pattern of rates, and specifically in the certificate rate, therefore, propose only a sufficient withdrawal of support from the market to end the virtually automatic availability of Federal Reserve credit, which is an inevitable aspect of the pegging of that rate, and restoration to the System of at least some limited degree of control over the timing and volume of its open market operations.

Any consideration of the credit control policy problem confronting the System has to recognize that the two primary causes of inflationary pressures are the volume of money already created and the insufficiency of production in relation to the existing money supply. No credit control proposals so far suggested are adequate in themselves to meet this problem, particularly in the immediate future.

The principal arguments or groups of arguments which have been raised against a more restrictive open market policy are the following:

(1) If it resulted in a substantial rise in short-term rates, the interest cost on the public debt would be increased, refunding operations of the Treasury would be made difficult, redemptions of Savings bonds and notes might be substantially increased, and bank earnings which are already high would be increased further. Even though the rise in rates were not substantial, the interest cost to the Treasury would be larger than if the present rates on certificates were maintained.

(2) Higher interest rates, unless much higher, would not deter significantly private borrowing of the types that have been showing rapid expansion.

(3) Unless increases in rates were sizable, a wide differential between yields on short and long Governments would remain. After short-term rates again became stabilized at new and slightly higher levels, banks would again tend to buy longer-term Treasury bonds from nonbank investors to increase their earnings, and would sell short-term securities to the Reserve Banks to the extent necessary to maintain their required reserves.

In reply, the proponents of the suggested change in policy would make the following points:

(1) It is not proposed that the System permit short-term interest rates to rise without limit; in fact, it is proposed that the System intervene in the short-term market to the extent necessary to permit the Treasury to continue its refunding operations successfully, and in the long-term market to the extent necessary to protect the 2 1/2 per cent rate. Any rise in short-term rates within the range contemplated would still permit the Treasury to refund bank-held securities, maturing or callable over the next few years, at a lower average interest

rate than the rates now paid on those securities. Consequently, bank earnings are more likely to be reduced than increased for this reason alone; furthermore, less free availability of Federal Reserve credit might tend to dampen the rate of credit expansion and thus restrict the growth in the total earning assets of the banks. If any rise in interest costs on the debt should result, it would be small and gradual and would be easily borne in an inflationary period when incomes are high.

(2) There is no expectation that a small rise in short-term rates would deter borrowers. But the essential point is the termination of a situation in which the commercial banks can dictate the amount of Federal Reserve credit available by offering short-term securities in the market which the System is forced to buy to prevent a rise in rates. The change of policy would create uncertainty as to the amount of Federal Reserve credit which would be made available at any given time and as to the rate at which it could be obtained, and thus would tend to induce a somewhat more cautious attitude on the part of the banks in extending credit to their customers or in engaging in investment operations.

(3) Uncertainty concerning the prospect for interest rates would increase the risk of price fluctuations in the longer-term eligible bonds and thus discourage shifts by the banks from short-term to longer-term securities.

It is not likely that there is any disagreement within the System as to the ineffectiveness of a small rise in short-term interest rates as a deterrent to borrowers. The principal point with respect to which there is room for difference of opinion is the degree of effectiveness of a less automatic and somewhat reduced availability of Federal Reserve credit and greater uncertainty as to the prospect for interest rates as a deterrent to bank lending and investing operations. There is some reason to believe, however, that the change of policy suggested, while modest in its scope, would have desirable effects, and it appears to be the only policy change of much consequence which is open to the System under its existing powers.

Over the next few years it is possible that changes in the maturity distribution of the public debt might make it feasible to go somewhat farther in the direction of restoration of a free market for Government securities than seems safe at the moment. The securities now outstanding will move closer to maturity with the passage of time and those of the intermediate maturities will become less susceptible to wide price fluctuations in the event of a rise in short-term interest rates. The refunding policies of the Treasury might be adapted so as to provide a debt structure which would be appropriate to a more flexible interest rate policy. This is a problem which should be given careful study by the System in order that the authorities would be in a position to make suitable recommendations to the Treasury.

Alternative Supplementary Methods

The discussion under this heading can be limited to the proposals advanced in the Board's Annual Report for 1945, as no other plans have been suggested that appear to have been as well thought out or as practicable.

Aside from specific objections that have been raised against one or another of the three proposals, the criticisms that have been made of the proposals generally are along the following lines:

(1) If there is a problem with respect to the adequacy of credit controls, it is of the Board's own making, since the Board has refused to use its present powers and has made commitments that are unnecessary and undesirable in an inflationary period.

(2) Adoption of any or all of the proposals would involve further unnecessary interference with bank management; the proposals are advanced just at a time when the general trend is toward the elimination or relaxation of governmental controls that are not demonstrably necessary to the proper functioning of the economy.

(3) To press for such further interference with the operations of commercial banks would alienate the group upon which the System must rely, more than on any other, for support of its policies. Strong resistance from nonmember banks and probably from State banking departments and State governments to the application of the Board's proposals to nonmember banks is to be expected, and is likely to prevent approval by Congress; unless the restrictions and requirements are applied to all commercial banks, membership in the Federal Reserve System will be made unattractive, and many banks may give up their membership (converting to State charters where necessary), with the result that the System may be greatly weakened.

On the other hand, the following points are made in support of the Board's proposals:

(1) It is generally agreed that severe application of the instruments of credit control presently available would be too dangerous to be seriously contemplated, in view of the huge national debt, the necessity of frequent refunding operations, and the substantial proportions of the assets of commercial banks, savings banks, insurance companies, and other investing institutions and individuals which are now invested in Government obligations. It is the aim of the proposals to put the System in a position where it can use its existing powers without having the undesirable effects on the Government securities market which might occur under existing circumstances.

(2) While mild restrictive measures have been fairly successful thus far in restraining further monetization of the debt and further growth in the money supply from this source, and also in checking the tendency toward further declines in long term interest rates, one of the major influences toward restraint during the past year -- the retirement of Government debt by the use of surplus Government balances -- has been virtually completed, and there is no assurance that there will not be a renewal of the tendencies which gave cause for concern a year ago. Furthermore, the expansion of bank loans to private borrowers has gone largely unchecked, except for the types that are subject to selective credit controls, and it is quite possible that stronger measures will be needed in the future if any effective control over the volume of credit is to be maintained.

(3) It would be obviously unfair to apply restrictions only to one group of commercial banks, and if Congress should decline to grant the System authority to apply restrictions to all commercial banks, the responsibility for inadequate controls over credit and money supply would rest upon Congress and not upon the System.

More specific arguments for and against each of the three proposals made in the Board's report have been advanced. Each of the three proposals will, therefore, be discussed separately.

<u>Bond limitation plan</u>

The first proposal advanced in the Board's report is that the Board be authorized to place a maximum on the amounts of long term marketable securities, both public and private, that any commercial bank may hold against its net demand deposits. The objections that have been raised against this proposal are as follows:

(1) It would require substantial adjustments in the portfolios of a large proportion of the banks if the maximum holdings of long term securities which the banks were permitted to hold against their demand deposits were set low enough to be effective; earnings of many banks would be seriously affected, and some might be thrown "in the red"; the initial portfolio adjustment would not be final since banks presumably would have to make further sales of long term securities at least periodically whenever they lost demand deposits, unless they had corresponding increases in their time deposits.

(2) Considerable difficulty would be experienced in evolving a plan that would be fair to all banks -- that would take account of the varying amounts of other types of assets suitable for the investment of time deposits and capital funds such as mortgages, long term loans, and banking houses. Unless such assets were taken into account, some banks could in fact hold much higher proportions of long term securities against their demand deposits than others -- frequently the banks that were least in need of the higher earnings obtainable from longer term securities.

(3) There is no assurance that banks whose long term securities were less than they were permitted to hold would absorb the securities sold by banks that were forced to reduce their holdings. Consequently, the System might be faced with the alternatives either of permitting disorganization of the Government security market, or of absorbing the offerings of banks that were forced to sell, in amounts sufficient to prevent a material fall in prices and rise in yields, with the probable consequence of adding considerably to the basis for credit expansion in other forms. Furthermore, banks whose earnings were materially affected by the limitation would probably make shifts within their permitted holdings of long term securities from securities of relatively short maturity to securities of longer maturity, and considerable distortions in the interest rate pattern would be likely to result unless the System intervened on a substantial scale to absorb the shorter maturities. In that event an accentuation of tendencies toward lower long term rates would be likely.

(4) This plan would not be effective in checking credit expansion, except of one type -- the purchase of longer term eligible bonds from nonbank investors. In fact, the limitation on holdings of long term securities might encourage the banks to expand their loans (that was suggested as one of the probable results of the

Canadian Plan), especially if the banks were provided with additional excess reserves through Federal Reserve absorption of securities sold by banks that were required to reduce their holdings. The plan, therefore, is not pertinent to present problems, which now center around the rapid expansion of bank loans.

(5) The magnitude of the problem of debt monetization through bank purchases of eligible bonds from nonbank investors may not be as great as indicated in the Board's Annual Report, unless it is assumed that all maturing bonds are refunded into eligible issues during the next few years.

(6) One of the incidental purposes of the proposal apparently is to reduce bank earnings and this should not be recognized as a function of the Federal Reserve System.

Arguments advanced in support of this plan are as follows:

(1) It is not appropriate for commercial banks to hold large proportions of long term securities against their demand deposits.

(2) So far as the problem of adjustment in bank portfolios is concerned, the Board suggested that some administrative flexibility be authorized in carrying out such a plan, and if this suggestion were adopted, the banks could be given time in which to work out the necessary adjustments. Formulation of a fair and workable plan is a matter of detail and can be handled if there is agreement that the plan is basically desirable.

(3) The danger of expansion of the money supply through bank purchases of longer term Government securities from nonbank investors was amply demonstrated during and after the war. Even though it has been on a reduced scale for the past several months, there can be no assurance that it will not be resumed on a large scale in the future. Adoption of the plan, therefore, would afford protection against one potential source of further growth in the money supply.

(4) The plan would help to prevent further growth in bank earnings, which are already high; the Board has a general responsibility for conditions in the banking system that will promote the System's major objectives of monetary control, but will at the same time prevent excessive bank earnings.

Secondary reserve plan

The second proposal in the Board's Annual Report is that the Board be authorized to require all commercial banks to hold a specified percentage of Treasury bills and certificates as secondary reserves against their net demand deposits; the Board should be authorized to aid the banks in meeting this requirement by permitting them to hold vault cash or excess reserves in lieu of the specified securities. In this case, also, a number of criticisms have been leveled against the plan.

(1) This plan, like the first, would require wholesale adjustments in the portfolios of great numbers of banks if the secondary reserve requirements were placed high enough to be effective; here again, the earnings of a considerable number of banks would be seriously affected; and the initial adjustments would by no means be final -- every increase in a bank's demand deposits would require adjustments in its secondary reserve as well as in its primary reserve.

(2) The combined primary and secondary reserve requirements would force the banks to raise so large a proportion of new money against increases in their deposits resulting from extensions of credit to their customers, and consequently would involve such costs, either in the form of loss of income from other assets that would have to be disposed of, or as a result of increased indebtedness of the banks, as to be a serious deterrent to the making of loans. Consequently, the new requirement would be likely to interfere seriously with the financing by banks of their communities. The purpose of a restrictive policy is, of course, to restrict credit, but a pertinent question is whether restrictive action should be of such universal and indiscriminate application as to make it impossible to take account of varying conditions among the banks and their communities.

(3) One of the principal advantages claimed for the plan is that it would permit the System to restrict the availability of credit without increasing the interest cost on that part of the public debt which is held by the banks; but if such an increase in the interest cost on that part of the debt were to be prevented, the requirement would have to be held at a rather high level, regardless of changes in economic conditions. The use of the requirement as a credit control instrument, however, presumes variations in the requirement in response to changing economic conditions. But in view of the far-reaching effects of changes in the requirement, as well as the possible effects on the interest cost of the debt, there would be serious danger that changes in the requirement

would be delayed until the need for the changes became so obvious that the action would tend to be too late.

(4) Frequent adjustments in the requirement would probably be necessary because of Treasury financing operations and changes in the volume of reserve securities outstanding. For example, the redemption of part or all of an outstanding certificate issue would reduce the secondary reserves of many banks below the levels required up to that time, and when Federal Reserve holdings of the issue were substantial, many banks would not receive enough additions to their primary reserves through the Treasury payments to offset the reduction in their secondary reserves. On the other hand, if an issue of nonreserve securities, such as Treasury notes, were refunded with a certificate issue, many banks would have substantial additions to their secondary reserves, so that, unless the requirement were raised, it would no longer be effective as a credit control instrument. On the other hand, a lifting of the requirement in such a situation would involve difficulties for banks that did not hold the maturing note issues.

(5) It cannot be assumed that if the requirement were set at a level sufficient to freeze bank holdings of bills and certificates at the levels then current, banks with surplus holdings would choose to sell part of their holdings to banks with deficiencies. Unless the System intervened by selling bills and certificates and buying longer maturities freely, substantial distortions in the pattern of rates would result. If the System intervened, substantial shifts of the System's holdings into longer maturities and a large increase in Reserve Bank earnings would result, so that it would appear that the Reserve Banks were benefiting at the expense of their member banks.

(6) Adoption of the secondary reserve requirement would tend to cause a rise in interest rates on nongovernment obligations, with a consequent fall in their value, which would interfere with business financing and would tend to have much the same disturbing effects on investing institutions and other investors as would a fall in prices of Government securities. Furthermore, unless the System extended its support to the medium and longer term Government securities, a fall in their prices and a rise in yields would be likely. If support were given only to the longest maturities, Treasury financing outside the banks would probably have to be done almost exclusively at the 2 1/2 per cent rate, and the over-all interest cost on the debt might then be increased, rather than reduced. On the other hand, if the entire maturity range of Government securities were given support by the System, there would be danger that the banks would be supplied with so large an amount of additional primary reserves, that the effectiveness of the secondary reserve requirement would be nullified.

In support of the secondary reserve proposal, the following points may be made:

(1) It is not desirable to permit commercial banks to purchase and hold large proportions of the longer term securities against their demand deposits; such holdings of Government securities involve unnecessarily large interest cost to the Government and hence to the tax payers, and purchases from nonbank investors result in further additions to the money supply. Readjustments in bank security portfolios, therefore, would be appropriate, and it would be desirable to adopt measures that would check further monetization of the public debt.

(2) Aside from such considerations, the main purpose of the requirement would be to restrict the ability of banks to expand the credit volume through loans at times when loans are tending to expand rapidly and restrictions on growth in the money supply were desirable. The requirement would force banks to become more selective in their extensions of credit, but would not make it impossible for them to meet demands from their communities for credit for productive purposes.

(3) The requirement could be adjusted from time to time in response to changing economic conditions. It would be no more inflexible than the authority to change primary reserve requirements, but, as in the case of that authority, important changes presumably would be made only in connection with major changes in credit policy.

(4) By cooperation between the Treasury and the Reserve System, the need for frequent adjustments in secondary reserve requirements because of Treasury debt operations could be minimized.

(5) It should be assumed that the System would operate in the Government security market to the extent, but only to the extent, necessary to maintain stable conditions, especially in the long term sector market. It is not likely that operations would have to be on so large a scale as to nullify the effectiveness of the secondary reserve requirement.

(6) The System would in general supplement the secondary reserve plan by use of its traditional instruments for purposes of general credit control. In fact, some such supplementary powers are essential before the System would be in a position to make effective use of its traditional instruments.

Additional authority to raise reserve requirements

This proposal would involve chiefly an extension of the Board's present authority to change the amount of primary reserves which commercial banks would be required to maintain against demand deposits. Such authority over member banks is already a familiar instrument of System policy, and consequently needs no such extended discussion as the secondary reserve proposal. Arguments against a further grant of authority to increase primary reserve requirements are as follows:

(1) The Board does not need such additional authority -- the situation has changed drastically since the end of 1940 when the System previously advanced a similar proposal, as excess reserves of member banks, which were then beyond the capacity of the System to absorb them, have virtually disappeared, and the System now has a huge portfolio of Government securities which makes it easily possible to control the reserve position of member banks, even if there should be a substantial inflow of gold or return flow of currency from circulation.

(2) If, in an effort to restrict the banks' ability to extend credit without causing the rise in short term interest rates which would be caused by a restrictive open market policy, the Board should increase reserve requirements and at the same time buy freely in the market the securities which commercial banks were forced to sell, the only result would be to shift securities from the commercial banks to the Reserve Banks, and to reduce the earnings of the former, while increasing substantially the earnings of the latter.

(3) This proposal would make it necessary for higher requirements to be imposed upon nonmember as well as member banks and would require legislation of a nature that would meet strong opposition. Unless Congress should authorize the Board to fix the reserve requirements of nonmember banks (which is unlikely), not only would nonmember banks be discouraged from becoming members, but banks that are now members would be given incentive to get out of the Reserve System. Consequently, an attempt to restrict credit by this means might prove to be self-defeating.

(4) The proposal has some of the same defects as the secondary reserve plan, in that it would affect all banks alike regardless of their current reserve position, and regardless of the character of their lending and investing activities; and past experience has shown changes in reserve requirements to be a clumsy instrument, which is likely to have more drastic effects than are intended, and which, therefore, the System is likely to be reluctant to use until a situation becomes so clear that action is too late.

Against these objections the following arguments are made:

(1) It is true that the reserve position of member banks is within range of control by open market operations, because the large portfolio of Government securities now held by the Reserve Banks, but not without danger of causing a substantial rise in interest rates, a fall in security prices, and an increase in the interest cost on the public debt.

(2) Even though the banks did meet the higher reserve requirements by selling Government securities to the Reserve Bank, that would not mean that the rise in requirements was ineffective as a method of restraining credit expansion. During the past year we have seen the banks regain rapidly, by selling securities to the Reserve Banks, the reserve funds they lost through Treasury redemption operations, but it was evident that these operations had the effect of exerting recurrent pressure on the banks, and inducing some restraint in their purchases of longer term Government securities and other extensions of credit. Furthermore, the higher the reserve requirement, the less credit expansion is possible on the basis of a given amount of reserves.

(3) The Board has recommended that if increased authority over member bank reserve requirements is granted, the Board be authorized to apply the same requirements to nonmember banks. It is not reasonable to suppose that Congress would refuse to grant authority over reserve requirements of nonmember banks, if it became apparent that without such authority the Federal Reserve System might be seriously weakened.

(4) The System has other instruments at its disposal for mild action, and would not expect to order frequent changes in the banks' reserve requirements; such changes would be reserved for situations in which strong action was indicated.

(5) With a larger proportion of the outstanding public debt in the hands of the Federal Reserve Banks, it would be possible for the System to employ its discount rate and open market instruments more freely with less danger of wide repercussions upon the Government security market and the banking system.

Conclusions

It is evident from the foregoing discussion that arguments can be raised against as well as for any action which the System might take in an effort to use its existing powers to restrain credit expansion, and also with respect to each of the proposals advanced in the Board's Annual Report. In the existing situation, which is unusually complex because of the magnitude of the debt and its effects on the banking and monetary system, it is not possible to say definitely which line of action will clearly accomplish the major objectives of central bank policy with the least incidental adverse effects. Yet, a do-nothing policy would be least appropriate of all.

The first problem before those responsible for System policy is whether to rely upon presently available instruments of credit policy supplemented by public debt operations and probably by fiscal policy; or whether to press for legislative approval of new or enlarged authority to control credit. It would appear from the preceding analysis that while the former course would permit mild action to restrain credit expansion, it would give no assurance that in a strongly inflationary situation it would permit an effective degree of restraint on credit expansion, unless it were carried far enough to have material effects on the interest cost of the public debt and on prices of outstanding securities. On the other hand, it would avoid the necessity of forcing the issue with respect to enlarged powers in a year in which Congress has before it a number of more immediately pressing problems and when the public is restive about governmental controls. If the latter course were followed and the requested powers were granted, the System would be provided with new instruments or enlarged authority which would make possible stronger action to restrain credit expansion with less effect on the interest cost of the public debt and on the market value of at least that part of the public debt held by banks. But this course would have the disadvantage of arousing strenuous opposition and possible animosity toward the System, since it would involve innovations and since application of the proposed new powers to nonmember banks would be essential.

For the purpose of checking further monetization of the public debt through bank purchases of longer-term eligible bonds from nonbank investors, the bond limitation plan would be the most directly effective, although both the second and third proposals would undoubtedly be indirectly effective. From the viewpoint of effectiveness in restraining credit expansion generally, either the secondary reserve plan or increased primary reserve requirements would be clearly superior to the bond limitation plan. As between the secondary reserve plan and increased primary reserve requirements, the latter has the advantage of greater familiarity and greater simplicity and less interference with the banks' management of their earning assets. The secondary reserve plan, on the other hand, has the advantage to the banks of permitting them to hold short-term, low-yielding securities in place of part of the cash assets which they would have to hold if higher primary reserves were required, and to nonmember banks of not disturbing their present reserve requirements.

There are some technical aspects of the credit control problem that merit further study. For instance, there needs to be developed a long-run plan for debt management policy. It is possible that a coordinated program of policy using traditional instruments and debt management policy would be adequate for meeting the overall credit control problem. Study of possibilities along this line might show that effective control would not be possible without reenforcement by a special reserve plan of the type suggested by the Board. In this connection, it is felt that further study should be made, especially of the primary and secondary reserve plans, with the object of determining more definitely their limitations and what adaptations might be made to remedy such defects.

For the present there is no indication that strong measures are likely to be needed in the near future, but in view of the already greatly expanded money supply and the potential for further credit expansion, the monetary and credit situation can be an unstabilizing influence for many years. This analysis, therefore, is offered in the hope that it may be helpful to those responsible for System policy in formulating a program for the future.

<u>Committee and Associates</u>

Karl Bopp	D. S. Thompson
J. E. Horbett	Clarence Tow
W. H. Irons	Woodlief Thomas
P. W. McCracken	O. P. Wheeler
H. V. Roelse	R. A. Young

C. A. Sienkiewicz, Chairman