BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date February 15, 1946

To Chairman Eccles

From Woodlief Thomas

Subject: Increase in Reserve Requirements at Central Reserve City Banks

Attached is a memorandum prepared in accordance with your request discussing the question of increasing reserve requirements at central reserve city banks. This memorandum presents the facts and analyzes the pros and cons but contains no recommendations on the subject.

Would you like to have copies of it sent to other Board Members?

W. T.

Attachment

INCREASE IN RESERVE REQUIREMENTS AT CENTRAL RESERVE CITY BANKS

One means by which the Board could limit further bank credit expansion would be to increase reserve requirements at central reserve city banks. Under the law requirements against demand deposits at these banks could be increased from the present level of 20 per cent to 26 per cent -- the level from which they were reduced in 1942.

The principal justification for taking such action at this time would be to force these banks to reduce their holdings of Government securities. Under present circumstances, however, this suggested action would have little effect in checking further credit expansion. This may be said because the banks affected hold no excess reserves at present and, therefore, would probably meet the increased requirements by selling securities to the Reserve Banks or by borrowing, thus creating additional reserves. Excess reserves held by outside banks would probably not be absorbed because, with short-term Government security yields pegged at the present low rates, it is not likely that these would want to purchase the short-term securities offered by the central reserve city banks. Other objections to the action are that it imposes added restrictions on banks which have shown the smallest amount of credit expansion in the war period, rather than on those that have had more actual expansion and now have the basis for more potential expansion.

Effect of Increase

At the present level of deposits an increase in reserve requirements against demand deposits at central reserve city banks to 26 per cent would raise the amount of required reserves at these banks by about $1\frac{1}{2}$ billion dollars. The effect in each city is shown in the following table:

Deposits and Required Reserves of Central Reserve City Banks
Week Ending February 1, 1946
(In millions of dollars)

	New York	Chicago	Total
Net demand deposits	19,896	4,305	24,201
Time deposits	1,284	732	2,016
Required reserves			
Actual	4,056	905	4,961
With 26% against demand deposits	5,250	1,163	6,413
Increase	1,194	258	1,452

Since these banks hold no excess reserves and practically no balances with correspondent banks, they would have to meet the increased requirements by borrowing or more probably by liquidating Government securities. As shown in the following table, banks would have to make up the deficiency in reserves mainly by selling holdings of intermediate-term Government securities. Bills held by New York City banks amount to less than half the additional requirements and Chicago banks do not have enough to cover the increase. In any event, since present bill holdings are used for close adjustment of reserve balances to meet day-to-day and week-to-week changes, and in Chicago for special local tax usage, the banks would probably not want to reduce their holdings of bills. The greater part of the adjustment therefore would probably be in holdings of certificates or perhaps notes. Some banks might sell bonds but it is likely that most of them would want to hold on to their bonds in order to maintain their earnings position. It is unlikely that loans or holdings of other securities would be affected materially in adjusting the reserve position.

Holdings of U.S. Government Securities
Weekly Reporting Member Banks, February 6, 1946
(In millions of dollars)

	New York 1/	Chicago
Treasury bills	540	214
Treasury certificates	3,608	1,599
Treasury notes	2,728	657
Treasury bonds 2/	9,568	1,901

1/ Central reserve city banks in New York hold about 10 per cent more than do weekly reporting banks.

2/ It is estimated from other data that about 6 per cent of bond holdings mature or are callable within one year and over 50 per cent within five years.

Since the necessary adjustment in reserves would almost certainly create a flurry of trading in the Government securities market, any increases in requirements probably should be made in graduated steps, possibly in steps of 2 per cent each, such as were employed in the 1942 reductions.

Reasons in Favor of Increase

The following reasons may be advanced in favor of increasing reserve requirements at central reserve city banks at this time:

(1) The action would make use of a remaining power possessed by the System to check further credit expansion. It would eliminate a special wartime adjustment made when it was desirable to encourage banks to purchase additional amounts of Government securities and when the central reserve city banks were short of reserves. Now that banks do not need to purchase additional securities and, in fact, hold somewhat more than is necessary for a sound economy, there may be good reason for reimposing this restriction.

(2) By depriving banks of some of their increased holdings of short-term securities, it might discourage the recent tendency to shift from short to longer term securities. This tendency has been more pronounced at New York City banks than at banks elsewhere. As indicated in the following table the percentage of Treasury bonds to total Government security holdings has increased from around 50 per cent at New York City banks prior to 1943 to about 59 per cent at present. At banks elsewhere bonds comprised nearly 2/3 of total holdings in 1941; the ratio declined considerably in the first two years of the war to 50 per cent at reserve city banks and 55 per cent at country banks; and, although it has subsequently increased somewhat, it is still below prewar levels. In contrast to New York, Chicago banks have shown a steady decline in this proportion during the war.

Percentage of Treasury Bonds to Total Holdings of U.S. Government Securities, by Classes of Member Banks

	December 31, 1941	December 31, 1943	December 31, 1945
Central reserve city banks			
New York	50	48	59
Chicago	63	49	44
Reserve city banks	66	50	52
Country banks	67	55	61
All member banks	60	51	57

On this count some case could be made for increasing reserve requirements at New York City banks, but the case for an increase at Chicago banks on these grounds is weak. Except for the matter of local pride, Chicago banks might be reclassified as reserve city banks -- a change that is logical on many grounds. It should also be noted that both in dollar terms and in terms of percentage of increase, the wartime growth in Government security holdings of all kinds has been much smaller at central reserve city banks than at banks elsewhere.

(3) The action would reduce somewhat bank earnings from their present high levels. Central reserve city banks have a favorable earnings position and could stand some reduction in assets without any undesirable effect. As shown in the following table banks in New York and Chicago in 1945 showed net profits amounting to nearly 11 per cent of capital accounts, which is about the average for all member banks. The ratio for New York City banks has slightly more than doubled since 1940 while that for Chicago banks declined slightly. It should be noted, however, that the position of central reserve city banks with respect to earnings is no more favorable than that of other banks.

Ratio of Net Profits to Capital Accounts
By Classes of Member Banks, 1940 and 1945
(Per cent per annum)

	1940	1945
Central reserve city banks		
New York City	5.2	10.6
Chicago	12.4	10.8
Reserve city banks	7.3	11.2
Country banks	5.3	11.2
All member banks	6.2	10.9

(4) In case there should be a drift of funds from outside banks to central reserve city banks, reversing the wartime trend, the action would absorb some of the funds. Such a change in trend might result from (1) the coming to an end of Treasury deficits which tended to distribute funds throughout the country; (2) the expenditure of large accumulated liquid assets by holders outside the cities, and (3) the rebuilding of corporate and financial balances in large city banks.

Any such a shift of funds would create easy conditions in the money market because the central reserve city banks, which recently have been following a full-investment policy, would probably immediately put their funds to use, whereas some of these funds may now be held as excess reserves by country and reserve city banks.

There is as yet, however, no evidence of such a shift of funds and there is a possibility that it may not occur. Action to absorb the effect of such a shift could be deferred until its occurrence was more certain.

Reasons Against an Increase

Several strong reasons can be given for not increasing reserve requirements at central reserve city banks at this time:

(1) The change would not be particularly effective in preventing further credit expansion since central reserve city banks have no excess reserves. They would have to meet the increase by liquidating Government security holdings. They would probably sell short-term rather than long-term securities, and under the present policy of pegging yields, it is likely that most of these sales would be made to the Reserve Banks because other banks would not want the securities offered. Thus the effect of the increase upon the reserve position of the banks would be neutralized. The only effect of the change would be to reduce earning assets of central reserve city banks.

(2) The action would not absorb available excess reserves which are entirely held outside central reserve cities, mostly by country banks. If money rates were permitted to rise under the stimulus of city bank selling, it is possible that other banks might purchase the securities offered and thus absorb them without bringing into use additional reserve bank credit. At existing rates, however, it seems probable that these banks hold about all the short-term securities they want.

(3) The action might cause considerable upset in the money market. This would be the first time that reserve requirements were increased when banks did not have sufficient excess reserves to cover the additional requirements. Offerings of securities would disrupt the market somewhat. While Federal Reserve supporting action could, and no doubt should, be used to minimize this disruption, the operation might not be a smooth one. This would be particularly true if the action should be widely interpreted as a change in Federal Reserve policy and inspire the selling of securities not only by those banks that needed to adjust their reserve positions but by others which, for reasons rational or irrational, decided to do so.

(4) It would penalize central reserve city banks, which have had smaller gains in deposits during the war time than have other banks. It might be said with some justice, therefore, that these banks should not have additional restrictions imposed on them while other banks which expanded more rapidly are left unaffected. Changes in deposits by classes of banks during the war period are shown in the following table:

Member Bank Deposits by Classes of Banks
(War Loan Deposits Excluded)

	December 31, 1940	Daily Average January 1-15, 1946	Percentage increase
New York City*	17,744	22,573	27
Chicago*	3,710	5,504	48
Reserve city banks	19,844	41,068	107
Country banks	15,132	38,259	153
Total	56,430	107,404	90

* Central Reserve City banks only.

(5) The proposed increase would widen the differentials in reserve requirements between classes of cities. As a long-run policy it is desirable to work toward closer uniformity in these requirements in order to enhance the precision of credit control action.

Conclusion

In view of the desirability of checking credit expansion or even of eliminating some of the expansion that has already taken place, and in view of the limited powers available for accomplishing this purpose, it may be advisable to increase reserve requirements at central reserve city banks in the near future. Such action would have but limited effect and would not be entirely equitable, since the existing situation points to more need for restriction at outside banks than at central reserve city banks, but it might be expedient in view of the fact that there exists only authority for this limited action.

W.T.