FEDERAL RESERVE BANK
OF NEW YORK

June 1, 1942.

The Honorable Marriner S. Eccles,
Chairman, Federal Open Market Committee,
c/o Board of Governors of the Federal
Reserve System,
Washington, D.C.

Dear Chairman Eccles:

Preparatory to our meeting with the Treasury staff on Wednesday, I have put down some ideas concerning credit policy and Treasury financing. I am sending them along to you and to the other members of the Executive Committee of the Federal Open Market Committee, not as a finished product, but as something to stimulate our thinking on the problem.

Yours faithfully,

Allan Sproul,
President.

Enc.

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EXCESS RESERVES, RESERVE REQUIREMENTS, CREDIT POLICY AND TREASURY FINANCING.

We have consistently taken the view that a large volume of excess reserves is not necessary to assure the success of the war financing program. Wehave also held the view that the retreat from the excessive excess reserves of the pre-war period should be gradual, so that we might watch its effects on Treasury financing and on interest rates. Finally, we have recommended that the market volume of short-term Treasury paper (bills and certificates) be substantially increased, so as to make more effective whatever aggregate volume of reserves is available to the banks, and so as to provide a convenient medium of System open market operations.

The problem has now become one of determining whether and when the natural decline in excess reserves should be arrested, and by what means. It is obvious that the Federal Reserve Banks are going to have to supply a very large amount of reserve funds to the banks of the country, during the next fiscal year, in order to enable the banks to subscribe to succeeding issues of government securities in the amounts indicated to be necessary. It has been estimated that during the fiscal year the amount of government securities to be absorbed by commercial banks may be in the neighborhood of \$30 billions. Except to the extent that this expansion in bank investments is offset by a reduction in loans, it is to be expected that there will be a corresponding rise in deposits and a proportionate increase in the reserve requirements of the banks. If there is no change in the volume of loans and an increase of \$2 billions in the amount of currency outstanding, the increase in deposits which would accompany purchases of \$30 billions of government securities by the banks would be \$28 billions. Assuming no change in the percentages of reserves which member banks are required to maintain, but a greater growth of deposits in reserve city and country banks than in central reserve city banks, the increase in required reserves would be in the neighborhood of \$5 billions, which, with the estimated increase of \$2 billions in currency circulation, would require \$7 billions of reserve funds. At the beginning of the fiscal year, excess reserves will probably be between \$2 and \$2½ billions, so that about \$5 billions of additional reserve funds will have to be provided during the year

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even though excess reserves were allowed to disappear.

Should we begin to provide such funds immediately in sufficient volume to maintain the present level of excess reserves, or should we allow excess reserves to decline further, and if so, how far? By what method (reduction in reserve requirements, open market operations, or bank borrowing) should these additional reserve funds be made available to the banks, either now or in the future? These questions demand answers which are related not only to the war financing program, but also to the situation with which we shall have to contend in the post-war period.

The experience of the past seventeen months sheds some light on these questions. Since the beginning of 1941, excess reserves of all member banks have shrunk from nearly $7 billions to about $2½ billions, and in New York City excess reserves have been reduced by about 85%, without harmful effects on interest rates and without interference with the success of Treasury financing. The market has been subject to various disturbing influences in recent months and has shown occasional weakness, but these situations have been taken care of without difficulty by System open market operations. Short-term rates have risen, but these rates are still low, and the moderate rise which has occurred has had the beneficial effect of promoting wider distribution of short-term government securities.

This experience does not determine for us the precise amounts of excess reserves which might need to be maintained, either in the country as a whole or in the central money market, to assure satisfactory response to Treasury offerings of new securities. It does indicate, and experience in recent weeks further confirms the indication, that if the shrinkage in excess reserves is not so abrupt as to cause disturbance in the money market, and is cushioned by open market operations, when necessary, it can probably proceed considerably further without materially affecting interest rates or the response to new issues of government securities. For example, since the first of April excess reserves of New York City banks have been reduced from approximately $900 millions to about $500 millions. In the interval Treasury financing has been in the largest volume ever attempted in such a short spaceof time,

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the new issues have been well absorbed, and the government security market, in general, was stronger at the end of the period than at the beginning. There is evidence here that bank participation in war financing to whatever extent is necessary will depend, not on the maintenance of any particular amount of excess reserves, but upon the degree of ease with which additional reserves can be obtained.

This suggests that the most desirable credit program would be one which would permit a further reduction in the amount of excess reserves, while giving additional assurance that whatever amount of reserve funds is needed by the banks to support the Treasury's financing program will be readily available. The means of doing this without danger to the Treasury's financing program are at hand.

The first step would be to determine the level of reserve requirements which we wish to try to maintain during the war and immediate post-war periods. Assuming that this would be below the present level, it could then be announced that reserve requirements would be reduced to the determined level. Meanwhile, of course, we should continue with measures designed to bring into effective use whatever volume of reserves is available throughout the country.

Under present conditions some justification for lowering reserve requirements is not hard to find. Requirements were raised to present levels at a time when excess reserves were much larger and a rapid expansion of bank loans, at least partly to finance inventory accumulation, seemed to justify action to restrain unnecessary credit expansion. There is now little evidence of unnecessary expansion of bank loans, and we know that a considerable expansion of bank credit, in the form of enlarged holdings of government securities, will be essential to the success of the war financing program.

Nor is there obvious need for the wide differentials which now exist between the reserve requirements of the three principal classes of member banks. Prior to August, 1936, the differential between the reserve requirements against demand deposits for country banks and for central reserve city banks was 6 percentage points; now it is 12 percentage points. Partly as a consequence of this wide differential, banks

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in the large cities, and particularly in New York City, are less favorably situated with respect to excess reserves than banks whose percentage reserve requirements are lower.

Furthermore, the current figures on excess reserves of the various classes of banks do not accurately portray their true position. In addition to having proportionately much larger excess reserves in their balances with the Reserve Banks, country banks have balances with city correspondents, a considerable part of which are the equivalent of excess reserves. These claims of country banks upon city banks is in excess of the excess reserves of the city banks. In considering reductions in reserve requirements, therefore, it would seem appropriate to effect proportionately greater reductions in reserve requirements of central reserve city banks than of reserve city banks, and proportionately greater reductions in reserve requirements of reserve city banks than of country banks.

In considering how far to go in reducing the percentage reserve requirements of member banks, however, it must be borne in mind that any reduction has the effect not only of increasing excess reserves, but also of increasing the ratio of potential credit expansion to a given amount of reserve funds. We are going to emerge from the war period with a greatly expanded money supply in the form of bank deposits and currency outstanding. If it can be avoided, it would be inadvisable to go so far in lowering reserve requirements during the war period as to increase greatly the possibility of an undesired credit expansion after the war is over.

There is another reason for not attempting to meet all of the demand for reserve funds during the war period by lowering bank reserve requirements. If war expenditures on the scale estimated for the coming fiscal year were continued a second year, the rise in currency in circulation might be in the neighborhood of $4 billions and the expansion in bank deposits at least $50 billions. A 50% reduction in reserve requirements, the maximum now permitted by law, would release only about $5 billions of reserves. Taking account of present excess reserves, this would provide only about half of the reserves which the banks would be required to hold against their in-

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creased deposits, after meeting anticipated currency withdrawals. There is a visible end to this road, therefore, and so long as it is being travelled questions will persist as to what is to be done when the end is reached.

The following figures are suggested as limits for reductions to be made in reserve requirements during the war period:

Percentages of Reserves to be Maintained against -

	Central Reserve City Banks	Reserve City Banks	Country Banks
Demand Deposits	20	16	12
Time Deposits	5	5	5

The approximate amount of reserves which would be released by reductions to these levels would be as follows (based on deposits in March — last published figures):

	(Millions of Dollars)
Central Reserve City Banks	$1,180
Reserve City Banks	610
Country Banks	220
	$2,010

If this program of reductions in reserve requirements were adopted, it should be done gradually or offsetting measures should be taken to avoid sudden large increases in excess reserves, with consequent disruption of the government security market. For example, if the reduction were effected in only two steps, the disruptive effects could be offset, to whatever extent seemed desirable, by calling for the transfer of funds from war loan deposit to the Reserve Banks, and then gradually releasing these funds through Treasury expenditures. In this way it would be possible to avoid a sudden overflow of funds in the money market, which would tend to cause an undesirable temporary run-up in security prices.

The timing of reductions in reserve requirements is not so important once the underlying policy has been determined and announced. It would seem advantageous, however, to begin the reductions before ~~the next~~ an income tax date, when Treasury receipts tend to be low, and borrowing heavy. For example, the first reduction might be made effective on August 15, to be followed by the second or succeeding reductions on whatever schedule is adopted.

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Open market operations meanwhile would be directed continuously toward helping maintain whatever pattern or range of rates in the government security market may be agreed upon with the Treasury. On balance the System would do more buying than selling, thus supplementing the reserve funds provided by a reduction in reserve requirements. Open market operations, on the basis of recent experience, however, could maintain a pattern of rates without also maintaining the volume of excess reserves. Gradually, existing excess reserves and those newly created by the lowering of reserve requirements, would be reduced as a result of rising bank deposits and increased currency circulation. Eventually, if this program were adopted, banks would have to begin to borrow from the Federal Reserve Banks if they were to continue to subscribe to new issues of government securities. It may be questioned whether the banks could be depended upon to subscribe for the necessary volume of Treasury securities, at the rates now contemplated, if they had to obtain all of the necessary reserve funds through borrowing. As part of a program involving a lowering of reserve requirements, continued use of open market operations, and some preparation for the borrowing phase, bank borrowing is practicable. A schedule of discount rates would have to be devised and announced which would permit the banks to borrow from the Reserve Banks, without loss or with some profit, when borrowing was necessary in order that they might subscribe for and carry new issues of government securities. Even then, however, banks might feel that the purchase of government securities, when they had to borrow reserves to do so, involved a net loss if government deposits continued to be subject to assessment for the support of the Federal Deposit Insurance Corporation. It is suggested, therefore, that government deposits be exempted from this assessment, since these secured deposits create no risk for the Federal Deposit Insurance Corporation and since this would facilitate the Treasury's financing program. Finally, it could be arranged, if necessary, to have some of the leading banks of the country set the fashion, so that no discredit would adhere to the practice of borrowing reserves in order to continue to participate in financing the war. Under such conditions, it is believed that the banks would resume the habit of borrowing from the Federal Reserve

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Banks; that a semi-automatic method of providing additional reserve funds where needed in the banking system would have been established, and that the Federal Reserve System would be placed in a preferred position as to credit control.

Unless some such combination program of providing the banks of the country with reserve funds can be devised and made operative, it is difficult to see how the use of bank credit in financing the war program is to be kept at a minimum, or how we are to retain a satisfactory degree of control of credit in the post-war period.

June 1, 1942.

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