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C O P Y

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Subject Current Problems with Respect to Excess Reserves, Treasury Bills, and Interest Rates

SUMMARY

Excess reserves on October 27, 1943, amounted to $1.1 billions. It now appears probable that the total drain on these excess reserves for the remainder of the year will amount to about $2-1/4 billions. If no conscious steps are taken to meet this drain, it will nevertheless be met in one way or another by the "natural" operations of the money market. Letting it drift in this manner might result, however, in a substantial tightening of the market and a general rise in the whole structure of interest rates.

The prospective drain might be met, in whole or in part, in four different ways:

(1) By reducing the present volume of excess reserves,

(2) By member bank rediscounts with the Federal Reserve Banks,

(3) By reducing reserve requirements, or

(4) By Federal Reserve purchases of United States securities.

Drawing on either of the first two sources would, in our opinion, be incompatible with the objective of maintaining the present structure of interest rates. The third, the reduction of reserve requirements, is primarily a matter of Federal Reserve policy with respect to which it does not appear desirable to make a recommendation to the Federal Reserve Board at the present time. If reserve requirements are not reduced, however -- or to the extent to which such a reduction, if made, fails to meet the entire problem -- it will be necessary that the required reserve funds be supplied by purchases of United States securities. It seems desirable that these purchases be concentrated principally in Treasury bills, although if such purchases should prove insufficient, vigorous purchases of other securities, particularly certificates, should be made also.

Treasury bills have acquired an important function as secondary reserves in banks in the larger cities, and it is important that the necessary Federal Reserve purchases should not be acquired at the expense of stripping these banks of their bill holdings. It seems desirable, therefore, that the outstanding amount of Treasury bills should be substantially increased if the Federal Reserve Banks are to purchase a large amount of United States securities between now and the end of the year.

It does not appear desirable at the present time that the rate on Treasury bills should be changed or that the Federal Reserve Banks should replace their weekly bill maturities by direct purchases from the Treasury. Neither does it appear desirable, for reasons given in a previous memorandum, that the present series of bills and certificates should be replaced by 3/4 per cent 9-month bills.

I. Federal Reserve Operations So Far This Year

Excess reserves on October 27, 1943, amounted to $1,062 millions. This is a decrease of about $900 millions since the beginning of the year, and is only $42 millions higher than the low of $1,020 millions made on July 28. (See attached chart.)

The principal factor operating so far this year to reduce excess reserves has been the rapid growth of money in circulation which has amounted to $3.7 billions. The other major factor which would have worked to reduce excess reserves -- the increase in required reserves which accompanies the growth of deposits -- was offset during this period by the growth of War Loan deposits against which, under last April's legislation, no reserves are required. If it had not been for this legislation, it would have been necessary for the Federal Reserve Banks to have purchased $3.3 billions of Government securities in addition to the $3.1 billions which they actually did acquire on net balance, in order to have maintained excess reserves at their present level.

II. Probable Reserve Changes During the Rest of the Year

The following table indicates that during the last two months of the year, it will be necessary for the Federal Reserve System to provide for gross additions of approximately $2.2 billions to member bank reserves, or for equivalent reductions to be made in member bank reserve requirements, if excess reserves are to be maintained at their current level.

The increase of money in circulation assumed by the table is the same as that which occurred during the corresponding period of last year. The $8 billions decrease in War Loan account assumes that this account will be reduced to between $9 billions and $10 billions by the end of the year. The $1.4 billions, or thereabouts, of additional reserve funds which such a decrease would absorb would have been required earlier in the year had it not been for the April legislation referred to in the preceding section. The table assumes that Treasruy deposits in the Federal Reserve Banks will be reduced to about $200 millions at the year end.

	Billions of dollars	
Increase of money in circulation	1.3	
Less reserve released	.2	1.1
Increase in required reserves due to transfers of $8 billions from War Loan to private deposits		1.4
		2.5
Less decrease in Treasury deposits in Federal Reserve Banks		.3
Net drain of excess reserves		2.2

III. Should Existing Excess Reserves Be Further Reduced?

Only a small portion of the anticipated drain on reserve funds would be provided by allowing excess reserves to decline to the bare minimum, which would be held in any event by country banks. We do not believe that any of the drain should be met in this manner.

A comfortable margin of excess reserves is necessary to provide the "feel" of easy money. How large a volume this is depends upon the psychology of the market. The "feel" of easy money has been reasonably (although not completely) maintained, however, while excess reserves have been reduced by about 85 percent from $7 billions to $1.1 billions. There has grown up in the past few months, however, considerable talk about a "natural" rise in interest rates which is said to be now occurring. Under present circumstances, this can mean only that the market is losing some of its "feel" of easy money. It would seem best, therefore, that excess reserves should not be permitted to fall appreciably below their present level during this period.

IV. Rediscounting by Member Banks and Reduction of Reserve Requirements as Means of Meeting the Anticipated Drain

It seems to us that reliance on member bank rediscounting to supply any substantial portion of the needed reserve funds would be incompatible with the objective of maintaining the present structure of interest rates.

In order to provide any substantial proportion of the necessary reserve funds, it would be necessary for rediscounts to rise higher than they have been at any time since the few weeks immediately following the bank holiday. Such an increase in rediscounts would, in our opinion, place a tremendous pressure on the present structure of interest rates. This would be so for two reasons:

(1) The whole tradition of rediscounting is such that bankers will have recourse to it only with great reluctance. Most banks, therefore, would not only withdraw entirely from the market for new securities, but would sell a substantial proportion of their existing portfolios before resorting to it.

(2) Even if bankers had no prejudice against rediscounting as such, the use of the rediscounting device would place a price of 1/2 of 1 percent on the use of Federal Reserve funds, and so would tend to raise interest rates generally.

Another method of meeting all or a part of the anticipated drain would be a reduction in reserve requirements. This method is compatible with the objective of maintaining the present structure of interest rates. We feel that the question of utilizing this instrument at this time is primarily a matter of Federal Reserve policy, since the considerations pro and con for reducing reserve requirements are so intricately tied up with questions of long-run central banking problems. To the extent that reserve requirements may be reduced, the necessity for all or a portion of the purchases of United States securities discussed in the next two sections would be obviated.

V. What Types of Government Securities Should the Federal Reserve System Buy?

To the extent that the anticipated drain is not met by a reduction in reserve requirements, it will be necessary -- if a severe strain on the present structure of interest rates is to be avoided -- that it be met by Federal Reserve purchases of United States securities. The question remains "What class of securities should be bought?"

Under present circumstances, Federal Reserve purchases of United States securities serve the two purposes of (1) providing necessary reserve funds, and (2) maintaining the existing structure of interest rates. These two purposes are not always consistent. Sometimes the maintenance of the structure of rates may call for the purchase of securities of some particular maturity when additional reserve funds are not needed, and vice versa. It is necessary, therefore, that there be some type of security, such as the Treasury bill, which can be purchased and sold for reserve purposes only and without reference to any particular structure of rates.

The amount, if any, of United States securities other than Treasury bills which it will be necessary for the Federal Reserve System to purchase before the end of the year for the purpose of maintaining the existing structure of rates cannot be foretold. The smaller the amount required for this purpose, the better; as purchases, particularly of longer securities, made for the purpose of "supporting the market" have a bad psychological effect and tend to discourage outside buying. It is important, therefore, that no pressure on the market be allowed to arise from a deficiency in reserve funds.

It would be ideal if all of the purchases which will be necessary for reserve purposes could be concentrated in bills, particularly inasmuch as over a billion dollars of the necessary reserve funds will be needed for the purpose of providing additional currency. A concentration of reserve purchases in bills may not be possible, however, for reasons described in the next section of this memorandum, in which case resort may have to be had to purchases of certificates as well as bills for reserve purposes.

VI. The Need for Additional Treasury Bills

Treasury bills have become, since the initiation of the posted rate, a type of secondary reserve for banks in the larger cities. These banks are now depending almost entirely upon their Treasury bill portfolios for the margin of safety in their day-to-day operations, which was provided during the Thirties by excess reserves. If they were stripped of their Treasury bill holdings, it would, consequently, have a material effect in tightening the money market.

The total amount of Treasury bills not held by the Federal Reserve Banks was about $7-1/2 billions on October 27. If the Federal Reserve System should purchase a substantial amount of these bills during the remainder of the year without any increase in the total supply, it would reduce bank holdings of bills to a dangerously low level from the standpoint of maintaining the existing ease in the money market. This would be particularly serious inasmuch as the banks which would be principally affected would be those in the larger cities, especially New York and Chicago. It is these banks upon which the

Treasury must depend in a pinch, and it is extremely important that they should be kept in a liquid position so that they will be potential buyers of Government securities in an emergency. This will be the case as long as their bill portfolios are adequate. (An interesting example, taken from British experience, of the manner in which a shortage of Treasury bills can result in a marked tightening of the money market is given by the excerpt from the Midland Bank Review for February-March 1939 which is appended to this memorandum. The role of the Treasury bill in the American money market is now somewhat similar to that assumed earlier by its British counterpart, as described in the excerpt.)

It is recommended, therefore, that the weekly issue of Treasury bills should be increased between now and the end of the year, unless the Federal Reserve Board determines to meet the entire problem by a reduction in reserve requirements. If the entire problem is to be met by purchases of United States securities, it would be desirable that the increase in Treasury bills should be $200 millions per week and should commence as soon as practicable. If the increase could be started on Friday, November 12, the outstanding amount of bills would be increased $1.6 billions by the end of the year.

If this increase is not adequate to provide the requisite reserve funds without too great a reduction in the bill portfolios of the New York and Chicago banks, it may be necessary for the Federal Reserve System to purchase certificates for reserve purposes. Such purchases, if needed, should be made vigorously, and it should be made clear to the market that they are being made for the purpose of providing reserves, rather than for that of supporting a sagging structure of rates. Any certificates so purchased could be replaced in the portfolios of the Reserve Banks with bills as soon as an adequate supply of bills became available.

VII. The Rate on Treasury Bills

This memorandum has been devoted so far to the question of meeting the anticipated drain on reserve funds for the remainder of this year. This drain will have to be met one way or another irrespective of whatever action, if any, is taken with respect to the rate on Treasury bills (or other Treasury securities), although some methods of providing the necessary funds -- as by rediscounts, for example -- would in themselves tend to raise rates. An increase in rates would not, however, help provide the necessary reserve funds. It must, therefore, be considered solely on its own merits.

It has been suggested that the rate on Treasury bills be raised to 1/2 of 1 percent.

The most important disadvantage of such action, aside from its immediate cost, is that it might disturb the entire structure of rates. Whether it would do this or not is a question of "feel" which it is very difficult to predict a priori. It is even more difficult to "Try it and see", however, as the experiment when once made may be irreversible.

Against this disadvantage of raising the bill rate, the contention is made that an increase in the rate might broaden the market. To the extent that this is true, it would merely mean that more banks would be induced to adjust their reserve positions through the medium of Treasury bills, rather than through that of excess reserves or bankers' balances. There would be no particular advantage for the Treasury or the money market in such a change; and there is no reason, therefore, why each banker should not be allowed to consult his own convenience in this respect. Even if a "broadening of the market" for bills would be of material advantage to the Treasury or the money market, however, it is doubtful if it would be achieved to any important extent by a 1/8 of 1 percent increase in the rate, inasmuch as the bulk of the existing excess reserves is held by country banks which are likely to be little more attracted to bills at 1/2 of 1 percent than at 3/8 of 1 percent.

Another and more sweeping proposal for raising the rate on short-term securities is that made by the Federal Reserve Board in its memorandum of July 13, 1943, that the present series of bills and certificates be withdrawn altogether and replaced by new 3/4 percent 9-month Treasury bills. We feel that this proposal should not be adopted for reasons set forth at length in our memorandum of July 19, entitled "The Proposal of the Federal Reserve Board for the Issuance of 9-Month Treasury Bills."

VIII. The Proposal That the Federal Reserve System Replace Its Holdings of Maturing Bills by Direct Purchase from the Treasury

There remains a final question with respect to the appropriate manner of distribution of Treasury bills. The Federal Reserve System has proposed that the Federal Reserve Banks be permitted to purchase directly from the Treasury each week an amount of Treasury bills equal to the amount held in the System portfolio maturing that week.

There is no economic or mechanical objection to this procedure. It would accomplish the same thing as is being accomplished now, and accomplish it with fewer transactions. Neither is the adoption of the proposal necessary, however, as an adequate volume of bids could easily be arranged through banks or dealers. Furthermore, even if such prearrangement should be considered undesirable, an adequate volume of bids would develop on its own account if the rate at issuance were allowed to rise slightly above the posted rate of 0.375 percent; and such a rise would cause no alarm if the market were given a prior indication that it was to occur.

The argument against the procedure proposed by the Federal Reserve System is simply that it would result in both the Treasury and the System -- but particularly the Treasury -- being subjected to unnecessary censure in order to accomplish an objective which could be as well accomplished without incurring such censure.

There is still a substantial body of opinion in the country at large which opposes direct purchase of Government securities by the central bank. As long as this sentiment exists and the desired objectives of Treasury and Federal Reserve policy can be accomplished equally well without resorting to such purchases, there seems to be no reason why the censure should be risked.

Attachments

Treasury proposal would continue present situation except in two respects:

(1) The market would determine the underwriting profit, instead of having it fixed at a minimum by the Fed.

(2) There would be slightly less certainty about covering the offering each week.

It differs from Board proposal, in that latter would completely eliminate underwriting profit to market on bills replacing Fed's maturities.

It does <u>nothing</u> to solve basic problem of pattern of rates.

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