75TH CONGRESS
1st Session

SENATE

DOCUMENT
No. 19

# RESERVE REQUIREMENTS OF MEMBER BANKS OF THE FEDERAL RESERVE SYSTEM

LETTER

FROM

THE SECRETARY OF THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

TRANSMITTING

IN RESPONSE TO SENATE RESOLUTION No. 78
A REPORT ON THE RECENT ORDER OF THE BOARD
INCREASING THE RESERVE REQUIREMENTS OF
MEMBER BANKS ON MARCH 1, 1937
AND MAY 1, 1937

FEBRUARY 15, 1937.—Referred to the Committee on Banking and Currency and ordered to be printed, with illustrations

UNITED STATES
GOVERNMENT PRINTING OFFICE
WASHINGTON : 1937

# RESERVE REQUIREMENTS OF MEMBER BANKS OF THE FEDERAL RESERVE SYSTEM

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM,
*Washington, February 15, 1937.*

The PRESIDENT OF THE SENATE.

SIR: Reference is made to Senate Resolution 78, of February 5, 1937, requesting the Board of Governors of the Federal Reserve System to transmit to the Senate, as soon as practicable, a report setting forth the reasons for the issuance of the recent order of the Board increasing the reserve requirements of member banks after May 1, 1937, the actual and probable effect of such order with respect to interest rates upon public and private obligations, and its probable effect upon the banking system of the country.

The resolution was referred to the Board of Governors and in response thereto it has directed me to transmit to you the following: (1) The statement contained in the Board's minutes of January 30, which sets forth the substance of the action taken by the Board and the reasons therefor; (2) material, authorized by the Board for inclusion in the Federal Reserve Bulletin for February 1937, which relates to the ability of the banking system of the country to meet the present and prospective credit requirements of agriculture, commerce, and industry, to the reserve position of the member banks of the Federal Reserve System, and to the effects of proposed changes in reserve requirements; and (3) additional data with respect to interest rates upon public and private obligations.

The statement contained in the Board's minutes of January 30, setting forth the substance of its order increasing the reserve requirements of member banks and the reasons for this action, is as follows:

The Board of Governors of the Federal Reserve System today increased reserve requirements for member banks by 33⅓ percent, as follows: On demand deposits, at banks in central reserve cities, from 19½ to 26 percent; at banks in reserve cities, from 15 to 20 percent; and at "country" banks, from 10½ to 14 percent; on time deposits, at all banks, from 4½ to 6 percent. For the purpose of affording member banks ample time for orderly adjustment to the changed requirements, one-half of the increase will become effective as of the opening of business on March 1, 1937, and the remaining half will become effective as of the opening of business on May 1.

The following table shows what the reserve requirements are at present, what they will be from March 1 through April 30, and what they will be commencing May 1:

*Reserve requirements*

[Percent of deposits]

| Class of bank | Demand deposits | | | Time deposits | | |
|---|---|---|---|---|---|---|
| | Present requirements | Mar. 1 through Apr. 30 | May 1 and after | Present requirements | Mar. 1 through Apr. 30 | May 1 and after |
| Central reserve city | 19½ | 22¾ | 26 | 4½ | 5¼ | 6 |
| Reserve city | 15 | 17½ | 20 | 4½ | 5¼ | 6 |
| "Country" | 10½ | 12¼ | 14 | 4½ | 5¼ | 6 |

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This action completes the use of the Board's power under the law to raise reserve requirements to not more than twice the amount prescribed for member banks in section 19 of the Federal Reserve Act.

The section of the law which authorizes the Board to change reserve requirements for member banks states that when this power is used it shall be "in order to prevent injurious credit expansion or contraction." The significance of this language is that it places responsibility on the Board to use its power to change reserve requirements not only to counteract an injurious credit expansion or contraction after it has developed, but also to anticipate and prevent such an expansion or contraction.

By its present action the Board eliminates as a basis of possible credit expansion an estimated $1,500,000,000 of excess reserves which are superfluous for the present or prospective needs of commerce, industry, and agriculture and which, in the Board's judgment, would result in an injurious credit expansion if permitted to become the basis of a multiple expansion of bank credit. The Board estimates that, after the full increase has gone into effect, member banks will have excess reserves of approximately $500,000,000, an amount ample to finance further recovery and to maintain easy money conditions. At the same time the Federal Reserve System will be placed in a position where such reduction or expansion of member bank reserves as may be deemed in the public interest may be effected through open-market operations, a more flexible instrument, better adapted for keeping the reserve position of member banks currently in close adjustment to credit needs.

As the Board stated on July 15, 1936, in its announcement of the previous increase of reserve requirements, excess reserves then held by member banks had resulted almost entirely from the inflow of gold from abroad rather than from the System's credit policy. Since that time the country's gold stock has been further increased by a large inflow of gold, amounting to $600,000,000. Between the time of the banking holiday in 1933 and December 24, 1936, when the United States Treasury put into effect its program for preventing acquisitions of gold from adding to the country's banking reserves, the gold inflow aggregated approximately $4,000,000,000. This inflow of gold had the effect of adding an equal amount to the reserves of member banks as well as to their deposits. The total amount of deposits in banks and the Postal Savings System, plus currency outside of banks, is now $2,000,000,000 larger than in the summer of 1929.

The present volume of deposits, if utilized at a rate of turnover comparable to predepression levels, is sufficient to sustain a vastly greater rate of business activity than exists today In order to sustain and expand recovery, the country's commerce, industry, and agriculture, therefore, require a more complete and productive utilization of existing deposits rather than further additions to the amount now available.

The excess reserves of about $1,500,000,000 eliminated as a base of further credit expansion by this action could support an increase in the supply of money, in the form of bank credit, which beyond any doubt would constitute an injurious credit expansion.

The present is an opportune time for action because, as was the case when the Board announced its prior action last July, excess reserves are widely distributed among member banks, and balances with correspondent banks are twice as large as they have generally been in the past. All but a small number of member banks have more than sufficient excess reserves and surplus balances with other banks to meet a 33⅓-percent increase in reserve requirements. As of January 13, the Board's survey indicates that only 197 of the 6,367 member banks lacked sufficient funds to meet such an increase in reserve requirements by utilizing their present excess balances with the reserve banks and not more than one-half of their balances with correspondent banks. On this basis these 197 banks, in order to meet the full requirements, would have needed an additional $123,000,000, of which $110,000,000 would have been needed by banks in central reserve cities, $11,000,000 by banks in other reserve cities and only $2,300,000 by country banks.

Another reason for action at this time is that, as stated by the Board last July, "it is far better to sterilize a part of these superfluous reserves while they are still unused than to permit a credit structure to be erected upon them and then to withdraw the foundation of the structure."

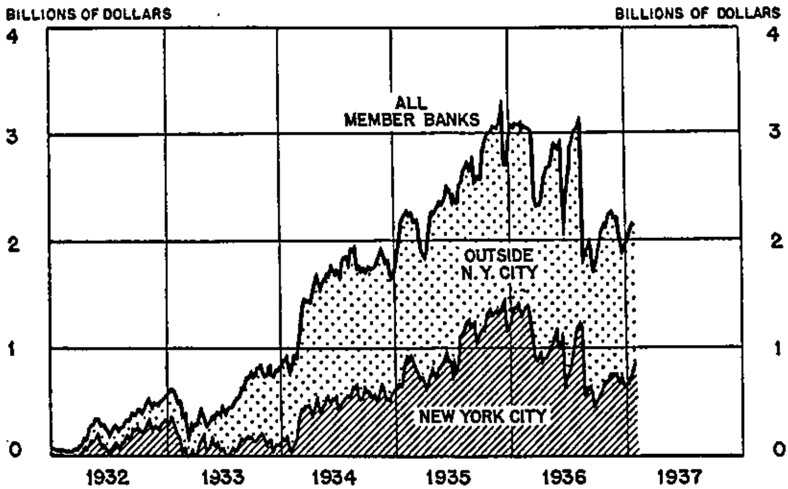
The available methods of absorbing excess reserves have been under consideration. It has been decided that under present circumstances changes in reserve requirements should precede reduction in reserves through open-market operations, because changes in requirements affect all banks, regardless of their reserve position, and consequently should be made while reserves are widely distributed.

This action increases reserve requirements to the full extent authorized by law. It is not the present intention of the Board to request from Congress additional authority to absorb excess reserves by means of raising reserve requirements.

It is the Board's expectation that, with approximately $500,000,000 of excess reserves remaining with the banks, credit conditions will continue to be easy. At the same time the Reserve System will be in a position to take promptly such action as may be desirable to ease or tighten credit conditions through open-market and rate policy.

In announcing the previous increase in reserve requirements, the Board said: "The prevailing level of long-time interest rates, which has been an important factor in the revival of the capital market, has been due principally to the large accumulations of idle funds in the hands of individual and institutional investors. The supply of investment funds is in excess of the demand. The increase in reserve requirements of member banks will not diminish the volume of deposits held by these banks for their customers and will, therefore, not diminish the volume of funds available for investment. The maintenance of an adequate supply of funds at favorable rates for capital purposes, including mortgages, is an important factor in bringing about and sustaining a lasting recovery."

EXCESS RESERVES OF MEMBER BANKS




The same considerations apply with equal force at the present time. The Board's action does not reduce the large volume of existing funds available for investment by depositors, and should not, therefore, occasion an advance in long-term interest rates or a restrictive policy on the part of institutional and other investors in meeting the needs for sound businesss, industrial and agricultural credit.

In view of all these considerations, the Board believes that the action taken at this time will operate to prevent an injurious credit expansion and at the same time give assurance for continued progress toward full recovery.

The following material, authorized by the Board for inclusion in the Federal Reserve Bulletin for February 1937, relates to the ability of the banking system of the country to meet the present and prospective credit requirements of agriculture, commerce, and industry, to the reserve position of the member banks of the Federal Reserve System, and to the effects of proposed changes in reserve requirements:

Member bank reserve balances with Federal Reserve banks on January 27, were $6,770,000,000, of which $4,620,000,000 were required reserves, leaving excess reserves of $2,150,000,000, as shown in the chart (p. 3). After reserve requirements were increased by 50 percent last August, excess reserves grew from $1,800,000,000 to $2,200,000,000 in November and early December. They were then temporarily reduced to $1,880,000,000 on December 23 as a result of withdrawals of currency into circulation to meet holiday demands and of the building up of Treasury deposits at the Reserve banks.

In the subsequent 5 weeks excess reserves increased once more as currency returned from circulation and Treasury deposits were reduced. Further growth of $120,000,000 in the country's gold stock from December 23 to January 27 was more than offset by an increase of $160,000,000 in Treasury holdings of cash, including inactive gold. An increase of foreign-bank and other nonmember deposits, amounting to $60,000,000 in the 5 weeks and to $100,000,000 since the beginning of December, has also withdrawn funds from member bank reserves.

The increase in money in circulation in the three months preceding Christmas amounted to $450,000,000, the largest in several years, while the decrease of $360,000,000 in the following 5 weeks was somewhat less than the usual seasonal amount, indicating that the growth of money in circulation, which has been pronounced in the past 2 years, continued over the holiday period.

Effects of the announced increase in reserve requirements upon the various classes of member banks are shown approximately in the following table based upon the reserve position of the banks as of January 27, 1937. It is not possible to show precisely how each group will be affected, because by the time of the effective dates of the two increases in requirements the total amount of reserves and their distribution among the various classes of banks and also the amount of deposits on which required reserves are based may have changed, although the changes within the next month will probably not be substantial. The figures indicate what the results would have been if the increase in reserve requirements had become effective on January 27. A factor that may considerably affect the distribution of reserves will be the withdrawal of bankers' balances by country banks from their city correspondents for the purpose of providing additional reserves needed.

*Reserve position of member banks, Jan. 27, 1937*

[In millions of dollars. Figures partly estimated]

| Class of bank | Reserves with Federal Reserve banks | | | Excess reserves after increase in required reserves of— | |
|---|---|---|---|---|---|
| | Total | Required | Excess | 16⅔ percent | 33⅓ percent |
| Central reserve city banks | 3,378 | 2,371 | 1,007 | 612 | 217 |
| Reserve city banks | 2,147 | 1,492 | 655 | 406 | 158 |
| "Country" banks | 1,248 | 756 | 492 | 366 | 240 |
| All member banks | 6,773 | 4,619 | 2,154 | 1,384 | 615 |

Figures in the table show that banks in each class taken as a whole, on the basis of their January 27 position, would still have had large excess reserves after the first 16⅔ percent increase in requirements, with country banks having the largest relative amount. The effect of the second increase will depend upon changes that may take place in the amount and distribution of member bank reserves by the end of April, but it would appear from the present situation that all the classes of banks would still have substantial excess reserves.

As pointed out in the Board's statement of January 30, a recent survey by the Board showed that all but 197 member banks, taken individually, were able to meet an increase of 33⅓ percent in reserve requirements either from excess reserves or by using one-half of their balances with correspondents, and all but 60 banks could meet an increase of 16⅔ percent in that way. The Board's survey covered the situation on January 13 and the additional reserves needed by banks in the various classes to meet increases in requirements of 16⅔ and 33⅓ percent as of that date are shown in the following table:

*Additional reserves required by member banks to meet increase in requirements, position as of Jan. 13, 1937*

[In millions of dollars]

| Class of bank | Increase of 16⅔ percent | | | Increase of 33⅓ percent | | |
|---|---|---|---|---|---|---|
| | Total | Obtainable by using one-half of bankers' balances | Required after using one-half of bankers' balances | Total | Obtainable by using one-half of bankers' balances | Required after using one-half of bankers' balances |
| Central reserve city banks | 28.0 | 8.0 | 20.0 | 147.1 | 37.6 | 109.5 |
| Reserve city banks | 48.0 | 47.8 | .2 | 159.0 | 148.0 | 11.0 |
| "Country" banks | 24.4 | 23.8 | .6 | 70.4 | 68.1 | 2.3 |
| All member banks | 100.4 | 79.6 | 20.8 | 376.5 | 253.7 | 122.8 |

These figures indicate that to meet a 16⅔-percent increase in requirements, member banks outside of the central reserve cities would need to raise about $70,000,000 of additional reserve funds, most of which would probably be obtained by withdrawals from balances with city correspondents. Probably half of these balances are held with reserve city banks, and some of the withdrawals will be absorbed by correspondent banks with adequate excess reserves, but a substantial portion of the withdrawals from reserve city banks will be met in turn by withdrawals from central reserve city banks. As a consequence, a large part of the additional reserve funds obtained from bankers' balances will in the end come from central reserve city banks, 15 of which on the basis of their position as of January 13 would need to raise $28,000,000 of additional reserves, in addition to meeting such withdrawals by correspondents as may occur. The other 35 central reserve city banks would still have over $500,000,000 of excess reserves. Since this survey was made the New York City banks as a whole, as shown in the chart on page 6, have increased their excess reserves by $100,000,000 and are in a position to meet the increase with a smaller amount of readjustment.

These figures indicate that the amounts involved in the necessary adjustment of reserve positions of member banks to the increase of 16⅔ percent in reserve requirements at the end of February will be smaller than those needed at the time of the 50 percent increase in requirements last August. At that time the change was accomplished with little effect on the money market. The effect of the final increase at the end of April will depend to a large extent upon the distribution of the excess reserves remaining at that time.

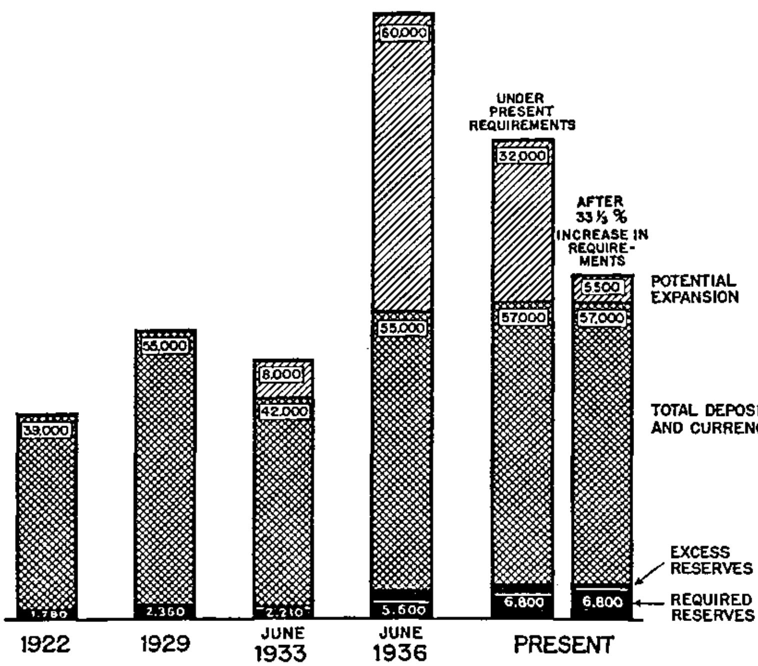
Growth of bank deposits and of currency in use by the public is limited by the amount of reserves held by banks. The total of deposits and currency outside banks is now larger than at any previous time, and the excess reserves held by member banks provide the basis for a further expansion in deposits. Increases in reserve requirements substantially reduce the magnitude of possible further credit expansion not only by decreasing the volume of excess reserves but also by lowering the ratio of expansion possible on the basis of a given amount of reserves. The chart (p. 6) shows for selected dates the relationship between member bank reserves, on the one hand, and all bank deposits plus currency outside of banks on the other, and also indicates the potential expansion on the basis of excess reserves outstanding on the dates shown.

In 1922 member banks held $1,780,000,000 of reserve balances with Federal Reserve banks and all bank deposits and currency at the disposal of the public aggregated about $39,000,000,000, or 22 times member bank reserves. By 1929 deposits and currency had expanded to $55,000,000,000 and reserves were $2,360,000,000, giving a ratio of more than 23 to 1. In those years member banks held only the minimum amount of reserves required. In June 1933 deposits and currency were $13,000,000,000 smaller than in 1929, but reserves held were only slightly smaller, and member banks held $360,000,000 of excess reserves, which would have permitted on the basis of the 1922 ratio an expansion of $8,000,000,000 in deposits. From June 1933 to June 1936, notwithstanding an increase in deposits and currency to the 1929 level, the growth of member bank reserves was so great that there were $2,700,000,000 of excess reserves. These reserves were sufficient to permit a further theoretical expansion of $60,000,000,000 in deposits. The increase in reserve requirements made last August considerably reduced the possible expansion, but at the beginning of this year, with deposits and currency $2,000,000,000 larger than the previous maximum, the $2,200,000,000 of excess reserves held by member banks could still support a further expansion of $32,000,000,000 in bank deposits and currency, an amount far in excess of the present or prospective needs of the country. The final increase in reserve requirements will reduce the amount of potential expansion in deposits and currency, on the basis of existing reserves, without recourse to the Reserve banks, to a maximum of $5,500,000,000.

In making these computations deposits of nonmember banks, as well as those of member banks, are included because nonmember banks hold most of their reserves with member banks, so that in the final analysis reserve deposits of member banks constitute reserves back of all deposits in the United States.

## RESERVES AND CREDIT EXPANSION

( In millions of dollars )




Changes in currency are also reflected in and limited by available member bank reserves.

The figures for potential expansion indicate the maximum possible expansion on the basis of reserves. The figures for June 1933 and June 1936, were computed by applying to excess reserves on those dates the 1922 ratio of reserves to deposits and currency. In computing potential expansion on the basis of excess reserves now outstanding the 1922 ratio was reduced by one-third to allow for the 50-percent increase in reserve requirements last August and by one-half to provide for the further increase to double previous requirements. In 1929 and 1933 corresponding ratios were somewhat larger than in 1922.

These figures indicate in a general way the nature of the changes in the credit situation effected by the further increase in reserve requirements; they are not exact measurements of what as a practical matter could have happened had there been no such increase. An expansion of as much as $60,000,000,000 or even of $32,000,000,000 in deposits and currency would not have been likely, because other forces would have prevented it, but a substantial movement in that direction would have been injurious to the business and credit system. The extent to which deposits and currency actually will expand in the future depends upon developments that may influence the attitude of borrowers and lenders, change the volume of reserves, or affect the composition of deposits and therefore the ratio of deposits and currency to required reserves. Increases or decreases in the amount of currency in circulation, for example, would affect reserves as well as the total supply of means of payment, and shifts in the relative importance of demand and time deposits, of deposits in the various classes of reserve cities, or of those at member and nonmember banks would change the ratio of potential expansion on the basis of a given amount of reserves.

The foregoing statements set forth the Board's expectation that credit conditions would continue to be easy after the increase in reserve requirements goes into effect. Inasmuch as the increase has not yet gone into effect, since the Board's order provides that half of the increase shall be effective at the opening of business March 1, 1937, and the remaining half at the opening of business May 1, 1937, whatever influence the Board's action may have had up to this time has been anticipatory and psychological in character. The possibility of such action by the Board has been the subject of discussion for some months past and it is thought that market expectations that such action would be taken have had some influence. On the other hand, so many factors affect interest rates that, in the Board's opinion, it would not be accurate to ascribe changes in these rates exclusively to the Board's action or to expectation that action would be taken.

A table giving the course of the principal available quotations of long- and short-time money rates in recent months follows:

*Money rates in New York City*

[Percent per annum]

| | In week ending— | | | | |
|---|---|---|---|---|---|
| | July 18, 1936 | Dec. 5, 1936 | Jan. 23, 1937 | Jan. 30, 1937 | Feb. 6, 1937 |
| Bankers' acceptances, 90-day unendorsed | 1/8 | 3/16 | 1/4 | 1/4 | 5/16 |
| Commercial paper, prime, 4-6 months | 3/4 | 3/4 | 3/4 | 3/4 | 3/4 |
| Stock-exchange call loans | 1.00 | 1.00 | 1.00 | 1.00 | 1.00 |
| U. S. Government obligations: | | | | | |
| Treasury bills, 9 months | .12 | .09 | .36 | .40 | .37 |
| Treasury notes, 3-5 years | 1.18 | .94 | 1.19 | 1.20 | 1.19 |
| Treasury bonds, 8 years and over | 2.50 | 2.25 | 2.30 | 2.31 | 2.31 |
| Corporate bonds, high-grade | 3.22 | 3.11 | 3.08 | 3.13 | 3.17 |
| Federal Reserve bank: | | | | | |
| Rediscount rate | 1 1/2 | 1 1/2 | 1 1/2 | 1 1/2 | 1 1/2 |
| Buying rate for bankers' acceptances, 90-day endorsed | 1/2 | 1/2 | 1/2 | 1/2 | 1/2 |

The Board hopes that the foregoing information meets fully the desires of the Senate as expressed in its resolution.

I am also directed by the Board to say that if there is any further information which the Senate may desire to have in connection with this subject, the Board will be pleased to furnish it if it is available.

Respectfully submitted.

CHESTER MORRILL, *Secretary.*

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