BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Date November 25, 1947

To Chairman Eccles

From Woodlief Thomas

MESSAGE:

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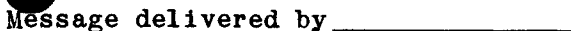

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F.R. 468
Rev. 1/47

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Federal Reserve Bank of St. Louis

November 25, 1947

PROPOSAL FOR A SPECIAL RESERVE REQUIREMENT AGAINST THE DEMAND AND TIME DEPOSITS OF BANKS

In order to provide a more effective means of restraining inflationary expansion of bank credit, the Board of Governors of the Federal Reserve System proposes that the Congress pass legislation granting the System's Federal Open Market Committee temporary authority to impose gradually as conditions may warrant a requirement that all commercial banks hold a special reserve. This reserve should be in addition to reserves required under existing laws and an average amount of operating funds customarily held by the banks, and consist of cash or cash items, interbank balances, balances with the Federal Reserve Banks, and Treasury bills, certificates, or notes. Legislation should provide that this authority be granted for a three-year period. The Federal Open Market Committee should have authority to vary the requirement in accordance with the needs of the situation and within the limits of a maximum fixed by law.

Need for the proposed measure.--This special requirement is necessary to enable the Federal Reserve System to limit the ability of banks to obtain additional reserves by selling part of the large holdings of Government securities and to reduce or offset the inflationary effects of increased bank reserves resulting from that source or from gold or currency movements.

Limitations on bank reserves are needed to restrain banks in meeting excessive demands for bank credit. At the present high level of employment and output, further expansion of the total volume of bank credit is inflationary because it would add to expenditures, which are already in excess of the productive capacity of this country's existing industrial structure and labor force.

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In order to meet private credit demands, banks have been selling Government securities in the market. The Federal Reserve System, which provides the ultimate market for Government securities, has had to purchase such securities. In maintaining orderly and stable market conditions the Federal Reserve System must be prepared at all times to purchase the Government securities not absorbed by other investors. Whenever the Federal Reserve purchases Government securities, additional bank reserves are thus created and these in turn supply the basis for an expansion in bank credit of many times their amount.

In this situation, the Federal Reserve System has no effective powers to prevent an increase in bank reserves either through gold acquisitions or through bank sales of securities. Use of the customary weapon of open market operations would involve the sale in the market of the Reserve System's holdings of Government securities and, therefore, is not a feasible means of offsetting increases in bank reserves. Under present conditions, such operations are impractical because of their possible disruptive effects upon the Government securities market. Orderly and relatively stable conditions in this market are essential to maintain the public's confidence in Government credit. Furthermore, avoidance of any undue increase in the interest cost on the Government's huge public debt is desirable as a matter of national policy and general public interest.

Likewise, higher Federal Reserve discount rates would have little or no effect, because the banks themselves have no occasion to borrow funds to maintain reserve positions as long as they can sell Government securities for this purpose.

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Under the proposed authority, banks could be limited in their ability to expand credit on the basis of new reserves resulting from gold or currency movements, from sales of their own holdings of Government securities, or from Federal Reserve support of the prices of long-term Government securities. In addition, it would divorce the Government securities market from private credit and permit the Federal Reserve System to use more effectively discount rates and open market operations to affect primarily conditions in the private credit market. Thus, the authority would make it possible to limit the volume and raise the cost of private credit without necessarily increasing the interest cost to the Government on a large part of the vast public debt outstanding.

Features of the special reserve plan.--Salient features of the proposed temporary authority may be briefly summarized as follows:

(1) The power to impose and to vary the special reserve requirement would be vested in the Federal Open Market Committee and would be limited by law to a temporary period of three years.

(2) The requirement would apply to all banks receiving demand deposits, including member banks of the Federal Reserve System and nonmember banks--insured and noninsured. It would not apply, however, to banks that do exclusively a savings business.

(3) The special reserve requirement would apply to both demand and time deposits and would be subject to a maximum limit fixed by statute. A maximum of 25 per cent of gross demand deposits and a maximum of 10 per cent of time deposits will probably be adequate for the temporary period covered by the proposed statute.

(4) Eligible special reserve assets would include:
   (a) The excess of specified cash assets over an allowance for existing reserve requirements and an average of customary operating funds of the banks; and
   (b) Obligations of the United States in the form of Treasury bills, certificates, and notes (with original maturities of 2 years or less).

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(5) Cash assets eligible for meeting the special reserve requirement would include:
   (a) Balances with Reserve Banks.
   (b) Coin and currency.
   (c) Cash items in process of collection.
   (d) Balances due from in excess of balances due to banks in U. S.

Only the excess of the sum of these items over a specified amount of customary operating funds, including the existing statutory allowance for required reserves, would be available for inclusion in the special reserve.

(6) The allowance for existing required reserves and customary operating funds would be fixed by statute at 20 per cent of gross demand deposits plus 6 per cent of time deposits.

(7) The requirement would be introduced gradually as credit conditions warrant. The authorizing statute could provide that, after a special reserve has been established of 10 per cent against gross demand deposits and 4 per cent against time deposits, further changes would not exceed 5 per cent of gross demand deposits and 2 per cent of time deposits at one time. Ample notice should be given before the effective date of such changes to allow banks adequate time to make adjustments.

(8) The following considerations should determine the timing of the introduction of, or changes in, the special reserve requirement:
   (a) The volume and ownership of special reserve assets and of other assets readily convertible into eligible assets;
   (b) Past and prospective gold movements, currency fluctuations, or other factors causing changes in the volume of bank reserves;
   (c) Conditions in the Government securities market;
   (d) The general credit situation.

(9) Special reserves and requirements would be computed on a daily average basis for monthly periods, or for other periods by classes of banks as the Open Market Committee might prescribe.

The penalty against average deficiencies in the requirement would be one-half per cent per month, payable to the United States.

(10) The Federal Open Market Committee would be authorized to issue regulations governing the administration of the requirement, to require necessary reports, and to delegate administration with respect to nonmember banks to other appropriate Federal or State banking agencies.

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Operation of the proposal.--Establishment of the special reserve requirement would accomplish two principal purposes: (1) it would reduce the amount of Government securities that banks would be willing to sell to obtain additional reserves; and (2) it would decrease the ratio of multiple credit expansion on the basis of a given amount of reserves. These results could be accomplished without reducing the volume of earning assets of banks.

The special reserve requirement would not deprive banks of any earning assets but would reduce the available amount of highly liquid and readily saleable assets which banks hold as secondary reserves to meet losses of deposits and new credit demands. Because of the reduction in available secondary reserves, banks would then be less willing to sell Government securities held in excess of the requirement in order to acquire higher-yielding loan or investment assets. Thus, an effect of the special reserve requirement would be to reduce the creation of new reserves and expansion of bank credit through monetization of the public debt.

Other instruments of Federal Reserve policy could be so used as to facilitate adjustment to the new requirement and subsequently would be employed to apply such additional restrictions or such easing as the general credit situation might require. One of the purposes of the proposed new requirement is to make possible the more effective use of the existing instruments in offsetting changes in bank reserves--particularly open market operations and discount rates--without seriously upsetting the Government securities market and unduly raising the interest cost on the public debt.

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The Federal Open Market Committee, which would have authority to apply and vary the requirement, is composed of all seven members of the Board of Governors of the Federal Reserve System and five representatives of the Federal Reserve Banks. The Committee's present authority covers the System's Government security and other open market operations. The use of the proposed special reserve requirement would be closely related to these operations.

Reduction in the ratio of multiple credit expansion on the basis of any addition to the supply of reserves would be an especially important effect of the special reserve requirement. How great a reduction would result from the present ratio of six or more to one would depend on the percentage requirement established. The ratio might be lowered to about two and one-half to one if the maximum special reserve requirement should be authorized.

The mere existence of power to impose a special reserve requirement would itself exert a strong restraining influence on bank credit expansion. Banks would need to guide their policies with an eye to the possible imposition of the requirement. The extent of use of the special reserve requirement would necessarily depend on developments in the general credit situation.

Restraint on further bank credit expansion by the proposed requirement, supplemented as the situation may warrant by other credit control measures, would not prevent the accommodation by banks of the economy's essential credit needs. The additional reserve requirement, however, would impose on banks a greater responsibility for meeting

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essential credit demands out of existing loanable funds. To expand loans, banks would need to sell securities of types that might be bought by other investors, rather than short-term Government securities which under present conditions are purchased principally by the Reserve Banks. The major effect of an active program to restrain bank credit expansion, for which the suggested reserve requirement is needed, would be to reduce materially the ready availability of bank credit to private borrowers at low interest rates.

Advantages of the proposal.--The proposed measure has many important advantages of alternative means of curbing credit expansion. Restraint on further bank credit expansion might be attempted by allowing short-term interest rates on both public and private credit to rise substantially, thus increasing the cost of borrowing and thereby seeking to deter borrowing. Such a policy, however, would greatly increase the cost to the Government of carrying the public debt and have disruptive effects on the Government securities market. Under the proposed authority, interest on private credit could be raised without increasing rates on Government securities. In other words, any penalty rates would be paid by those who are currently responsible for inflationary borrowing and who might be deterred by the higher rates and not by the Government, which is reducing indebtedness.

If inflationary expansion of total bank credit to private borrowers is to be restricted, the restraint must be placed primarily on the lender. Under present conditions, even such a substantial rise in short-term interest rates as one or two percentage points would not deter many borrowers, and might encourage further lending because of the additional

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profit inducement to the lender. Under the proposed measure, the restraint is placed primarily upon the lender which in this case is the banking system. The proposal would thus have the effect of retarding further bank credit expansion by limiting the ability of the banks to make credit available.

From the standpoint of its effect on the earning position of banks, the plan is superior to an increase in primary reserve requirements, because it would enable banks to retain earning assets that would have to be sold to meet an increase in primary reserve requirements. At the same time it would permit an increase in interest rates on private debt and would make possible an increase in earnings at banks where interest rates on loans are especially low. This could be accomplished without increasing the interest cost on the public debt. The continued profitability of bank operations is essential if the banks are to meet their increasing costs and build up adequate reserves while serving their communities constructively.

The specific form of the proposed special reserve requirement, as more fully described in the next section, is designed to fit the sort of banking system that exists in this country without alterations in its structure or drastic changes in its customary methods of operation. Banks that are not members of the Federal Reserve System would have to be included. Limitations of the requirement to member banks only would seriously weaken the Federal Reserve System by giving a great advantage to nonmembership and therefore would make the measure ineffective, as well as inequitable. It would assure equitable treatment of individual banks and groups of banks without requiring that all banks become subject to a single authority.

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The requirement would also make use of the practice of interbank deposits without interfering with the system of correspondent relations. It would require banks to hold a large portion of the Government securities that they were encouraged and permitted to buy to aid in war finance and still allow them to meet all essential credit needs of the economy. It would assure the maintenance of a high degree of liquidity and safety in the banking system during a period of rapid and uncertain economic change.

The Board believes that the proposed plan is the only practical method of dealing with the present monetary and credit situation because it assures that the pressures will be exerted at the places where restraint on bank credit expansion can be effective. At the same time the plan will protect the interests of the Government, the general public, and the banking system.

Formula for computing the special reserve requirement.--The assets that would be counted as special reserves include certain specified nonearning or cash assets, as well as Treasury bills, certificates of indebtedness, and notes having original maturities not exceeding two years. The eligible cash assets include balances with the Federal Reserve Banks, coin and currency, cash items in process of collection, and balances due from, in excess of balances due to, other banks in the United States. Only the excess of the sum of these items over an allowance for existing required reserves and operating funds customarily held by banks would be counted in the special reserve. In order to assure uniformity among banks, such allowance should be fixed by statute at 20 per cent of gross demand deposits and 6 per cent of time deposits.

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To accomplish the purposes of the special reserve authority, it is desirable that the formula include some margin of cash assets as well as the specified short-term Government securities. Confining the eligible special reserve assets to Government securities would cause difficulties to banks obtaining new funds and not holding adequate amounts of the required securities. A formula limited to these earning assets would also be no more effective in restricting further inflationary credit expansion.

Only Treasury bills, certificates, and short-term notes are proposed for inclusion in the special reserve and other Government securities are eliminated for a number of reasons. The volume of bills, certificates, and notes can be more easily limited to relatively stable amounts. To include all Government securities would make necessary the imposition of a very high reserve requirement for it to be effective. Inclusion of Government bonds within one or two years of maturity or call dates would cause sudden substantial increases and decreases in the amount of eligible reserve assets. It is appropriate for banks holding deposits subject to withdrawal to maintain a high degree of liquidity, provided by short-term assets. Inclusion of longer-term higher-rate securities would not stop banks from shifting their lower-rate issues to the Federal and purchasing the higher-rate bonds in the market. More of the latter are still held outside the banking system. Limitation of the requirement to the especially short-term issues would improve the market demand for these issues and help to maintain a lower rate on short-term Government borrowing without lowering long-term interest rates. Finally, banks would have to sell their higher-rate issues in order to expand loans and this would be more of a discouragement to lending than sale of short-term low-rate issues.

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An equitable formula should allow for the great variations among groups of banks with respect to basic reserve requirements and with respect to holdings of different types of cash assets, without interfering unduly with these requirements and practices. Reserve requirements for nonmember banks not only differ from those for member banks but also vary from State to State. Member banks may hold excess reserves with Federal Reserve Banks and also balances with correspondent banks. Nonmember banks hold both required and secondary reserves in the form of balances with correspondent banks and would no doubt prefer to continue holding much of their reserves in this form, even though permitted to hold deposits with Reserve Banks.

The formula proposed for the computation of cash assets eligible for satisfying the special reserve requirement takes these factors into consideration and therefore makes use of, without interfering with, correspondent bank relations, both for member and nonmember banks. The special reserve requirement would be in addition to a figure which takes account of the reserve requirements under existing law and average operating funds customarily held by the banks. For purposes of administrative simplicity, the proposed formula would be uniform for all banks.

Availability of special reserve assets.--The formula and its application to certain broad groups of insured banks, using aggregate figures as of June 30, 1947, is illustrated in Table 1 attached.

The table shows that each major group of banks have more than enough special reserve assets available to meet a requirement established at 10 per cent against gross demand deposits and 4 per cent against time deposits. At the statutory maximum suggested for the requirement--namely

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25 per cent against demand deposits and 10 per cent against time deposits--the different groups show deficiencies in holdings of eligible assets of varying percentage amounts.

The variation in the percentages of deficiency or excess at the selected levels is still wider, of course, when studied by groups of banks according to Federal Reserve Districts, as in Table 2, which shows holdings of special reserve assets and short-term Government bonds as percentages of gross demand deposits. All of these groups would be able to meet the lower level of requirements shown. Data by individual banks would show even greater differences.

In considering the deficiencies in eligible special reserve assets that banks might confront at certain requirement levels, it must be remembered that banks, as Table 2 shows, hold substantial amounts of short-term Government bonds that may be eventually refunded by the Treasury into eligible assets or that could be converted through the market into such assets. In addition to 16 billion dollars of Treasury bills, certificates, and notes, all commercial banks hold 4 billion dollars of bonds due or callable within one year and 27 billion due within one to five years, and these are widely distributed among banks. As these bonds are retired they can be refunded by the Treasury through issuance of special reserve eligible assets, depending on the need of the banking system and the demand for such assets. The Federal Reserve System, moreover, holds 20 billion dollars of Treasury bills, certificates, and notes, which banks could acquire by selling to the System other Government securities. About 12 billion dollars of eligible obligations are also held by nonbank investors.

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Another source of eligible assets is the current and prospective gold inflow, and any other increase in bank cash in excess of required reserves and customary operating funds would also be eligible to apply against the special reserve.

It is clear from an analysis of the bank position and the available reserve assets that the banking system would be able to meet any requirements within the limits of the proposal without severe adjustments and without undue limitation upon their ability to supply the essential credit needs of the economy. Authority for the System to vary the requirements would permit any alterations needed to meet changing situations.

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TABLE 1

ILLUSTRATIVE COMPUTATION OF SPECIAL RESERVE ASSETS, JUNE 30, 1947
(Based on aggregate figures in millions of dollars, by groups of banks)

Assets	Member banks				Nonmember insured banks
	Central reserve city		Reserve city	Country	
	New York	Chicago			
1. Gross demand deposits	22,683	5,037	31,983	27,659	11,891
2. Time deposits	1,459	871	11,269	14,475	6,349
3. Coin and currency	123	36	470	780	395
4. Cash items in process of collection	1,884	349	2,623	834	124
5. Excess of demand balances due from over demand deposits due to other banks in U. S.*	--	--	--	2,546	2,765
6. Balances with Federal Reserve Banks	4,166	973	6,274	4,628	--
7. Net cash assets* (3 + 4 + 5 + 6)	6,173	1,357	9,367	8,787	3,284
8. Deduct 20% of gross demand deposits plus 6% of time deposits	4,624	1,060	7,073	6,400	2,759
9. Excess cash assets* (7 - 8)	1,549	298	2,294	2,387	525
10. Treasury bills, certificates, and notes	2,015	606	4,874	5,191	2,932
11. Total special reserve assets* (9 + 10)	3,564	904	7,168	7,578	3,457
12. Special reserve required at given percentages:					
a. 10% against demand and 4% against time deposits	2,327	539	3,649	3,345	1,443
b. Maximum of 25% against demand and 10% against time deposits	5,817	1,346	9,123	8,362	3,608
13. Deficiency or excess of special reserve assets:*					
a. With 10% against demand and 4% against time deposits	+1,237	+365	+3,519	+4,234	+2,014
b. With 25% against demand and 10% against time deposits	-2,253	-443	-1,954	-784	-151
14. Percentage deficiency or excess of special reserve assets to demand deposits:					
a. With 10% against demand and 4% against time deposits	+5.5	+7.2	+11.0	+15.3	+16.9
b. With 25% against demand and 10% against time deposits	-9.9	-8.8	-6.1	-2.8	-1.3

* Figures shown for these items are computed on the basis of aggregates by groups of banks for the country as a whole; totals of figures computed separately for individual banks or from aggregates by districts would show somewhat different amounts of available cash assets for some of the groups.

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RATIOS OF AVAILABLE SPECIAL RESERVE ASSETS AND SHORT-TERM TREASURY BONDS TO GROSS DEMAND DEPOSITS, ALL INSURED COMMERCIAL BANKS, JUNE 30, 1947

	Per cent of gross demand deposits						
	Treasury bills, certificates, and notes	Excess cash assets[a]	Total special reserve assets	Deficiency or excess of special reserve assets if requirements are: 25% of demand and 10% of time deposits	Deficiency or excess of special reserve assets if requirements are: 10% of demand and 4% of time deposits	Treasury bonds due or callable[b]: Within 1 year	Treasury bonds due or callable[b]: Within 1-5 years
Central reserve city member banks							
New York	8.9	6.8	15.7	- 9.9	+ 5.5	5.7	27.8
Chicago	12.0	5.9	17.9	- 8.8	+ 7.2	4.2	23.4
Reserve city member banks							
Boston	10.3	7.1	17.5	- 8.6	+ 7.1	5.1	18.3
New York	9.3	9.4	18.7	-11.8	+ 6.5	3.5	31.7
Philadelphia	6.7	8.3	14.9	-11.3	+ 4.4	1.5	22.6
Cleveland	8.0	6.4	14.4	-14.2	+ 3.0	7.1	33.7
Richmond	12.9	7.4	20.3	- 7.0	+ 9.4	2.5	32.5
Atlanta	14.4	8.7	23.2	- 3.9	+12.3	3.5	20.0
Chicago	20.6	7.1	27.7	- 2.7	+15.5	5.9	36.9
St. Louis	10.3	6.3	16.6	-10.2	+ 5.9	5.1	24.2
Minneapolis	8.8	7.3	16.1	-10.7	+ 5.4	3.7	28.0
Kansas City	16.8	6.0	22.7	- 3.7	+12.2	4.8	19.1
Dallas	13.3	6.1	19.4	- 7.1	+ 8.8	2.2	18.4
San Francisco	22.9	7.6	30.5	- .9	+17.9	6.1	31.3
Total	15.2	7.2	22.4	- 6.1	+11.0	4.9	27.8
Country member banks							
Boston	12.6	6.4	18.9	-11.1	+ 6.9	5.0	37.3
New York	12.7	9.3	21.9	-11.5	+ 8.6	4.3	45.7
Philadelphia	18.7	10.1	28.8	- 4.4	+15.5	5.0	41.4
Cleveland	17.8	11.1	28.9	- 3.5	+15.9	4.8	40.2
Richmond	17.0	8.5	25.5	- 3.9	+13.8	4.3	31.8
Atlanta	19.7	5.1	24.8	- 3.3	+13.6	3.9	25.0
Chicago	21.6	10.5	32.1	+ .6	+19.5	5.9	41.8
St. Louis	21.7	3.8	25.5	- 3.2	+14.0	4.0	28.7
Minneapolis	23.8	6.4	30.2	- .3	+18.0	7.3	39.8
Kansas City	26.1	9.6	35.8	+ 9.3	+25.2	3.2	18.8
Dallas	21.3	11.1	32.4	+ 6.6	+22.1	2.9	16.7
San Francisco	17.6	7.9	25.5	- 4.9	+13.3	6.9	33.9
Total	18.8	8.6	27.4	- 2.8	+15.3	4.7	34.3
Nonmember insured commercial banks							
Boston	19.2	1.2	20.3	-15.8	+ 5.9	5.6	41.5
New York	15.1	1.7	16.8	-16.2	+ 3.6	4.5	39.9
Philadelphia	20.9	.3	21.2	-11.1	+ 8.3	3.8	35.6
Cleveland	22.0	4.8	26.8	- 6.3	+13.5	4.6	37.6
Richmond	20.4	.2	20.6	- 9.2	+ 8.7	5.8	29.5
Atlanta	25.2	6.8	32.0	+ 3.8	+20.7	3.0	22.9
Chicago	29.0	5.9	34.9	+ 3.1	+22.2	4.6	39.8
St. Louis	25.0	4.7	29.7	+ 2.7	+18.9	2.2	22.5
Minneapolis	39.6	3.9	43.5	+12.8	+31.2	6.4	32.5
Kansas City	28.0	7.3	35.3	+ 8.6	+24.6	2.9	20.5
Dallas	16.5	10.4	27.0	+ .8	+16.5	.9	18.3
San Francisco	19.6	.6	20.1	-16.6	+ 5.5	7.7	39.3
Total	24.7	4.4	29.1	- 1.3	+16.9	4.2	31.0

a/ Total of (1) balances with Federal Reserve Banks, (2) excess of demand balances due from over demand deposits due to banks in United States, (3) coin and currency, and (4) cash items in process of collection, less (5) the sum of 20 per cent of demand deposits and 6 per cent of time deposits.

b/ These ratios are based on estimated holdings of such Treasury bonds.

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM,
DIVISION OF BANK OPERATIONS,
NOVEMBER 18, 1947.

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