

## PRINCIPAL CRITICISMS OF SPECIAL RESERVE PROPOSAL

1. It is unnecessary because banks will exercise sufficient caution and self-restraint to prevent any excessive credit expansion.
2. It is not needed because existing powers possessed by the System are adequate to restrain credit expansion if the System would use them.
3. It will unduly restrict bank loans for productive purposes, reduce production, and perhaps lead to depression.
4. It means regimentation of banks, will unduly interfere with the operation of their business, and will be a step toward socialization.
5. It is a means of requiring banks to purchase and hold Government securities at any rates the Treasury may wish and in such amounts as the Federal Reserve may require.
6. It will not be effective in restricting bank lending unless interest rates are permitted to rise, a development which the proposal is partially designed to avoid.

## ANSWERS TO CRITICISMS OF BOARD PROPOSALS

### Criticism:

1. It is unnecessary because banks will exercise sufficient caution and self-restraint to prevent any excessive credit expansion.

### Answer:

If such self-restraint is exercised to a sufficient extent, imposition of the special reserve will be unnecessary. It is not reasonable, however, to expect that 15,000 banks in a competitive system, faced with a strong demand for loans of high quality and possessing adequate resources to meet those demands, will voluntarily refrain from making the loans. The problem arises only in part from unsound or speculative loans being made by banks; any expansion in the total volume of bank loans adds to inflationary pressures.

## ANSWERS TO CRITICISMS OF BOARD PROPOSALS

### Criticism:

2. It is not needed because existing powers possessed by the System are adequate to restrain credit expansion if the System would use them.

### Answer:

Existing powers are being and will continue to be used to the fullest extent possible without causing a severe break in the market for Government securities. Under these conditions, however, any further absorption of bank reserves is entirely dependent upon the maintenance of a surplus in the Federal budget and the continued retirement of public debt held by banks, particularly by Federal Reserve Banks. There will be little or no surplus in 1947 after March. Any surplus in 1949 will depend on ~~the~~ appropriations and tax legislation yet to be adopted.

Although sales of some of the large volume of Government securities held by the Federal Reserve System would absorb bank reserves, it is not possible for the System to reduce its holdings, particularly at a time when banks are selling theirs to expand other credit. Any attempt by the System to reduce its holdings would completely destroy the market and cause a sharp break in prices of Government bonds.

The discount rate should be kept high enough to penalize borrowing from the Federal Reserve, but its effectiveness is limited as long as banks can obtain reserves by selling securities.

The remaining power to raise regular reserve requirements at New York City and Chicago banks would be restrictive to a small degree, but would be met by sales of short-term securities by those banks to the Reserve System. These particular banks, moreover, have shown much less credit expansion than have other banks.

## ANSWERS TO CRITICISMS OF BOARD PROPOSALS

### Criticism:

3. It will unduly restrict bank loans for productive purposes, reduce production, and perhaps lead to depression.

### Answer:

The present situation is one of excess buying of limited supplies of goods and buying is being further enlarged by credit expansion; there can be considerable contraction in the volume of demand without bringing it below available supplies and such contraction is essential to avoid further price increases. It is better to run the risk of causing some moderate restriction at this time than to permit the further development of an unbalanced price and income structure that will inevitably crash.

The type of special reserve proposed, moreover, will not prevent banks from making essential loans. It is designed to encourage them to make loans out of the existing supply of loanable funds, replacing one loan with another or selling securities which the public or other banks may buy. At present banks are expanding the total volume of their loans by selling securities which only the Federal Reserve will buy, thereby creating additional reserves, which can be expanded by the banking system into loans and investments amounting to six or more times their amount. The special reserve requirement would also reduce this multiple expansion ratio.

## ANSWERS TO CRITICISMS OF BOARD PROPOSALS

### Criticism:

4. It means regimentation of banks, will unduly interfere with the operation of their business, and will be a step toward socialization.

### Answer:

The special reserve proposal will not impose any new revolutionary or drastic restrictions on banks. It will merely restrict somewhat their newly-acquired privilege of creating additional reserves by selling Government securities which only the Federal Reserve will buy. Banks have the privilege because of Federal Reserve action in providing them with reserves needed to purchase Government securities during the war and because of present Federal Reserve responsibilities for maintaining a stable and orderly market for Government securities. Before the war capacity of banks to expand credit was limited by available supply of reserves, which in turn was largely subject to Federal Reserve control. The special reserve proposal would restore some part of this control. It is thoroughly consistent with instruments that the Federal Reserve has previously had. The System has had power to raise regular reserve requirements, which would be a much more drastic measure and a greater burden on bank operations and earnings.

## ANSWERS TO CRITICISMS OF BOARD PROPOSALS

### Criticism:

5. It is a means of requiring banks to purchase and hold Government securities at any rates the Treasury may wish and in such amounts as the Federal Reserve may require.

### Answer:

The proposal is not designed to require banks to acquire any more securities than they now have, but to limit their ability to use their existing holdings to create new reserves. Banks, moreover, would have a choice of holding the specified securities or holding cash assets.

It is true that the proposal would establish a definite market for civilian types of low-rate Government securities and make unnecessary further increases in rates on these issues in order to discourage their sale to the Federal Reserve System. Similar arrangements with banks are in effect by law or by mutual agreement in many other countries, among them Canada, England, and Belgium