1/21/48
W.T.

CREDIT EXPANSION AND INFLATION

Bank credit expansion is now helping to finance continued inflation. This is true because business expenditures are exceeding business receipts and businesses are finding it necessary to borrow for expansion of plant and equipment and to meet increased working capital requirements. These borrowings, together with the borrowings of consumers and real estate owners, have been in excess of the supply of current savings available for investment. Businesses and individuals, therefore, find it necessary either to draw upon past savings or to borrow from banks. To the extent that past savings are used, the velocity of the existing money supply is increased. To the extent that funds are borrowed from banks, the total supply of money is expanded.

Funds to meet the increased credit needs are being obtained in part through sales of securities by banks, insurance companies, and perhaps other investors to the Federal Reserve System. Federal Reserve purchases of securities increase the supply of bank reserves and permit a multiple expansion of credit on the basis of the reserves provided.

Borrowing from banks by businesses and consumers is offsetting the anti-inflationary effects of the Government surplus and retirement of the public debt held by the banking system. The total of demand deposits and currency, which were reduced through Treasury surplus by 3.5 billion dollars in the first quarter of 1947, were increased by nearly 7.5 billion dollars through bank loan expansion during the remainder of the year. One of the most powerful anti-inflationary forces would be the continuance of a Treasury surplus but this, of course, will be weakened by prospective tax reductions.

In view of the heavy demand for capital from business, Treasury savings bonds drives cannot be relied upon to absorb existing savings and reduce inflationary pressures. In addition to continued Treasury surplus, the proceeds of which are used to retire Federal Reserve held securities, action to restrict the supply of reserves available to banks is the most effective anti-inflationary weapon that may be used under present conditions.

PROSPECTIVE RESERVE POSITION OF MEMBER BANKS
SECOND QUARTER 1948

In the second quarter of 1948 there will be a reversal of conditions prevailing in the first quarter. The Treasury will show an excess of expenditures over receipts and will draw down its balance with the Federal Reserve. The resulting increase in bank reserves will be augmented by further gold imports and partly offset by a seasonal increase in currency and an increase in required reserves of member banks.

In order to absorb the additional reserve funds thus made available to banks, the Federal Reserve would have to sell about 2 billion dollars of Government securities in the market. These sales can be made only to the extent that banks and other investors may wish to buy. If banks are using available funds to expand loans and other investors are also out of the market for Government securities, it will be difficult, if not impossible, for the System to effect any sales of securities in the market. To the extent that tax reductions become effective in the second quarter, the excess of Treasury expenditures will be increased.

Additional powers to absorb bank reserves will be needed by the System in order to restrict inflationary credit expansion without demoralization of the Government bond market.

Factors Affecting Bank Reserves and Federal Reserve Credit
March 31 to June 30, 1948

	In millions of dollars
Factors increasing reserves	
Treasury transactions (excluding retirement of securities held by Federal Reserve but including other public debt transactions by Treasury)	2,100
Gold acquisitions	500
Total	2,600
Factors reducing available reserves	
Required reserves--increase	500
Currency in circulation--increase	100
	600
Federal Reserve sales of Government securities needed to prevent increase in available reserves	2,000

PROSPECTIVE RESERVE POSITION OF MEMBER BANKS
FIRST QUARTER 1948

Factors Affecting Bank Reserves and Federal Reserve Credit
December 31, 1947 to March 31, 1948

	In millions of dollars
Factors decreasing bank reserves	
Treasury cash transactions (excluding retirement of securities held by Federal Reserve Banks but including other public debt transactions by Treasury)	6,800
Other factors	200
Total	7,000
Factors making ~~reserves~~ available	
Gold acquisitions	500
Currency in circulation--decrease	700
Required reserves of member banks--decrease	400
Excess reserves of member banks--decrease	700
Total	2,300
Federal Reserve System purchases of Government securities needed to maintain bank reserves	4,700
Purchases from nonbank investors (excluding about 400 million of purchases by Treasury for trust funds) may be about	1,700
Purchases from banks	3,000

PROSPECTIVE RESERVE POSITION OF MEMBER BANKS
FIRST QUARTER 1948

During the first quarter of 1948 an excess of Treasury tax receipts over current expenditures will enable the Treasury to build up large deposits with Federal Reserve Banks and thus withdraw reserve funds from commercial banks. This drain will make it necessary for commercial banks to liquidate some of their assets. Presumably this liquidation will take the form of sales of Government securities, most of which will be purchased by the Federal Reserve System. The need for liquidation of Government securities should put some pressure on banks and discourage them from expanding loans. Their ability to sell Government securities to the Federal Reserve may somewhat reduce this pressure.

There will be other substantial offsets to the drain from Treasury transactions, as set forth in the attached statement. In addition continued sales of securities by nonbank investors, particularly insurance companies, to the Federal Reserve will make substantial amounts of bank reserves available and reduce the pressure on banks to liquidate. Federal Reserve purchases of restricted bonds (not eligible to be held by banks) have already exceeded 800 million dollars during the first three weeks of January. The estimate given below assumes some slackening in these sales or an offset in the form of purchases of Treasury bills and certificates by nonbank investors.

These prospective developments offer the last opportunity until next year for the Treasury and the Federal Reserve to exert any pressure on banks under existing powers, except by attempting to sell Government securities from the System portfolio, which would result in a sharp decline in bond prices.

NEED FOR ADDITIONAL POWER TO INCREASE
RESERVE REQUIREMENTS

Federal Reserve authorities should be given additional power to increase reserve requirements of member banks and also power to require nonmember banks to hold reserves with Federal Reserve Banks in an amount corresponding to any increase in requirements for member banks over the present statutory maximum. The existing maximum and proposed new maximum requirements for the different classes are shown on the attached table.

Increases in reserve requirements for banks would decrease the ability of commercial banks to expand credit in two ways:

(1) Reduce funds available for credit expansion, either by decreasing excess reserves and by making it necessary for banks to sell part of their Government securities in order to meet the increased requirements.

(2) Lower the ratio of multiple credit expansion on the basis of a given increase in reserves from the present 6 or more to one to about 4 or 5 to one.

The suggested percentages would permit a somewhat larger relative increase in requirements for country banks than in those for city banks. This is proposed for the following reasons: (1) Country banks have expanded in recent years more than city banks, and (2) they have more capacity for further expansion than city banks, holding relatively more cash assets and short-term Government securities than city banks.

The maximum proposed requirements would permit an increase in the amount of reserves required to be held with Federal Reserve Banks of about 10.6 billion dollars above the maximum now permitted and of nearly 12 billion over present holdings.

Present and Proposed Maximum Required Reserves, by Class of Bank 1/

(In millions of dollars)

Class of bank	Required reserves		
	Present maximum 2/	Proposed maximum 3/	Increase
Member banks:			
Central reserve city........	6,916	9,355	2,439
Reserve city................	6,606	10,023	3,417
Country.....................	4,378	7,715	3,337
Nonmember banks 4/................	0	1,419	1,419
Total..............	17,900	28,512	10,612

1/ Based on deposits as of December 31, 1947 for member banks and estimated deposits as of November 26, 1947 for nonmember banks.

2/ For demand deposits -- central reserve city banks, 26 per cent; reserve city banks, 20 per cent; and country banks, 14 per cent. Time deposits -- all member banks, 6 per cent.

3/ For demand deposits -- central reserve city banks, 35 per cent; reserve city banks, 30 per cent; country banks, 25 per cent; and nonmember banks, 11 per cent. For time deposits -- all member banks, 10 per cent; nonmember banks, 4 per cent.

4/ Reserve requirements vary from State to State; figures shown cover only reserves that nonmember banks would be required to hold with Federal Reserve Banks.