Chairman Eccles:-

attached is a statement on a proposed increase in reserve requirements, prepared in accordance with your telephonic request.

E.A.G.

July 12, 1941.

July 11, 1941

INCREASE IN RESERVE REQUIREMENTS

Reserve requirements at present are at a level of 175 per cent of the statutory ratios. The Board has authority under the law to raise them by the remaining 25 per cent, or by about one-seventh of the present level. Such action would establish requirements for demand deposits at 14,20, and 26 per cent for the three classes of banks and for time deposits at 6 per cent for all banks. It would reduce excess reserves by 1.2 billion dollars from 5 to approximately 3.8 billion dollars. This amount of excess reserves could become the basis of a large further expansion of the already huge volume of bank credit.

The Board realizes that an increase of requirements by the relatively small amount permissible under the law would have relatively little effect on credit expansion, but the action would indicate that the Board considers that the time is ripe for exerting whatever restraining influence it can in the monetary field. It would also greatly strengthen the Board's position in asking for additional power over reserves.

Conditions have radically changed in the past few months. Last autumn and even early this year prices were not rising so fast and there was still a large amount of unused man power and plant capacity. At that time the Board could well ask for additional power over reserves and at the same time state that, while it had a limited authority that was still unused, there was for the moment no occasion to use it. Furthermore, when the occasion did arise the authority would certainly be inadequate.

Now the situation is different. The defense effort has been greatly intensified, Government outlays are on an enormous scale. The national income is at the highest level on record and is rapidly rising. With an ever-growing part of production being devoted to defense goods, with capacity production reached in many lines and shortages of many materials and classes of skilled labor developing, the rising income of the people is bidding up prices of consumers' goods, the supply of which is increasing at a much slower rate than spending power. Consequently, commodity prices have advanced sharply in the last few months and indications are that, as the program progresses, they will continue to advance and at an accelerated rate.

In these circumstances, the growth of seven billions in deposits and currency in the past year and the ability of banks to expand them still further becomes significant. It points clearly to the need of prompt action by the Board, first, to use such authority over reserves as it possesses, and then to ask emphatically for more authority.

The Board is aware of the fact that inflation cannot be averted by monetary action alone. It believes, in fact, that adequate taxation, increased savings, and greater industrial efficiency are more important than monetary action in controlling inflation. At the same time, a restraint on credit expansion would do its share to help prevent the development of a runaway situation. Since the regulation of the money supply is the particular responsibility of the Federal Reserve System, the Board would be remiss in the performance of its duties if it failed to urge on the Administration the adoption at this time of adequate restraints on credit growth.

The Board has been in accord with the Treasury in devising means for channelling past and current savings into Government bonds and in avoiding as far as possible further sales of Government obligations to the banks, which result in the creation of new deposits. At the same time the fact is that in the past twelve months commercial banks have purchased four billions of Government securities, constituting about two-thirds of the growth in the publicly offered Government debt. It is not consistent to discourage bank purchases of Government securities and at the same time to do nothing to diminish the pressure for investment exerted on banks by the presence of huge excess reserves.

With the great abundance of funds held by corporations and individuals and the constant stream of new money made available for investment by Government disbursements, there is no reason to believe that a reduction in excess reserves would result in a rise of money rates, except possibly in the excessively low rates on short-term money.

At the same time, the Board recognizes the fact that in the present emergency it should not act on bank reserves without consultation and agreement with the Treasury. It also recognizes that, if it raises reserve requirements, it must be prepared to offset by open-market operations any unforeseen unfavorable developments in the Government security market.

That there is no reason to expect any important effects on the Government security market from an increase of a billion and a quarter in required reserves is clear from the fact that by this action central reserve city banks would lose only $600 millions of their $2,450 millions of excess reserves; reserve city banks would lose \$350 millions out of \$1,650 millions and country banks - \$200 millions out of \$900 millions. For no group of banks would the reduction absorb as much as one-fourth of excess reserves.

A survey is being made of the reserve position of all individual member banks and the results of this survey will show how many banks will not be able to meet the proposed increase comfortably out of their existing reserves and balances with correspondents. There is no reason to believe that the number of such banks will be large or the amounts of possible shortages considerable.