

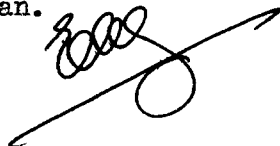
BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date October 13, 1941To Chairman EcclesSubject: Arguments against theFrom E. A. Goldenweiserceiling plan.

I attach a statement of the six principal objections that I can think of against the ceiling plan. I should appreciate it if you would read them and tell me of any others that may occur to you. I have also written possible answers to these objections. My own conviction in the matter is that we need additional powers and should get them in any form we can.

Attachment



October 13, 1941

ARGUMENTS AGAINST THE CEILING PLAN

The Plan. The ceiling plan proposes that the Board be given authority to require a higher reserve ratio for demand deposits in excess of the present amount. The authority might be limited to a ratio of 50, $66\frac{2}{3}$, or 75 per cent.

Arguments against the plan.

1. It would penalize growth, and consequently interfere with competition and thus remove incentive for good management.

Even though the ratio on new deposits be limited to between 50 and 75 per cent, so long as it is higher than the ratio on existing deposits, a bank has less incentive to compete for new deposits and gets less reward in the way of increase in available funds through good management.

2. The ceiling plan would be unintentionally deflationary, in addition to the intentional restraint, because if a bank on the 20 per cent reserve ratio lost, for example, \$100 in deposits (and reserves) the banking system would have to liquidate \$500, unless it borrowed, while the receipt of \$100 by another bank would make possible an expansion of only \$200, or \$150, depending on whether the requirement on new deposits were 50 per cent or $66\frac{2}{3}$ per cent. Such a deflationary influence might at times be undesirable.

3. The plan in operation would be very mild at first so long as the banks have a large amount of excess reserves. Each individual bank would have as large a volume of idle funds to invest as it now has. But it would become highly restrictive as the limit of expansion was approached. For example a $66\frac{2}{3}$ per cent requirement on new deposits would mean that the banks could expand by about 6 billions on the basis of present reserves. It would not meet the need for immediate restraint but might be too restrictive later when expansion has progressed farther.

4. Under the ceiling plan the ratio of required reserves to deposits would vary from bank to bank and this might make banks feel that it is unfair.

5. The plan is new and, therefore, raises many questions. It would be easier to obtain powers along familiar lines. Opening up a new approach might delay legislation and offer opportunities for the introduction of all kinds of amendments - such, for example, as the 100 per cent reserve plan.

6. The plan is contrary to the Board's commitment of the last year-end. Its introduction would be hard to reconcile with the Board's earlier position and would alienate banking support, and particularly that of the Federal Advisory Council and possibly of the Presidents of the Federal Reserve Banks.

Answers to these arguments may be stated as follows:

1. Any control of expansion penalizes growth; that is its purpose and expansion would be restrained at the very bank where it is in evidence. The argument is much more valid against a 100 per cent requirement on new deposits, which would make such deposits entirely unusable by the bank that receives them, than against a 50 to 75 per cent requirement, which would diminish but not eliminate the attractiveness of deposits. It would consequently not eliminate the incentive for attracting deposits by good management or otherwise.

2. This argument was much more valid when a 100 per cent reserve for new deposits was proposed to continue more or less indefinitely. It was then intended to meet this situation by reallocating ceilings. The argument also applies only to banks that have no excess reserves of which there are at present very few. With less than 100 per cent reserves on new deposits there is not much in the argument, especially if the plan is to be in effect only during the emergency, when restraint of expansion is what is desired. A recent survey shows that in the past three years only 300 banks out of 6,000 lost demand deposits and the losses aggregated only \$30,000,000, as against a total increase of \$12,000,000,000. In a period of expansion there is not much in this argument, and in a period of contraction the higher requirements would be rescinded.

3. It is true that the plan would become progressively more restrictive as expansion proceeded farther and the ultimate limit came

nearer. But is that not what we want? Is it not best to let banks know that they have a leeway but that there is an ultimate limit on total expansion? Isn't this true of any plan, except that this plan brings the limit nearer, and, therefore, is more effective against inflation?

4. The survey referred to above shows that in the past three years the rate of growth of deposits at different banks has not varied a great deal. In such circumstances the average ratio for the different banks would not vary either. In any case the over-all ratio is an academic concept. All banks will be subject to the same reserve requirements up to the ceiling and to the same reserve requirements above the ceiling. The total ratio need not and probably would not be computed.

5. Against the novelty argument nothing can be said, except that many new things have to be done under new conditions. Crank amendments can be attached to any banking legislation.

It is a question whether powers along the old familiar lines can be obtained more easily. There seems to be very strong opposition to them in the Treasury on the ground that they would immediately absorb existing excess reserves which the Treasury views as its cushion against possible difficulty in placing issues with non-banking investors. What the attitude of Congress will be is hard to say.

6. The Board's commitment is a policy matter for the Board to consider. It may feel that it is under obligation to repeat its previous request for power and in the same form. If it should find it

possible to obtain Administration support for such authority, it may be best to do that. But if that is not possible, the Board might feel free to ask for powers in a modified form, for that is all the ceiling plan represents.

In addition to these answers to the arguments against the ceiling plan this additional point should be made: after the powers have been obtained it will be much easier to get prompt action and acquiescence of the Treasury if the use of the powers will place no bank under the necessity of liquidating its assets or borrowing. If prompt action is wanted it is much more likely to be taken under the ceiling plan than under the ratio plan.