M. S. ECCLES STATEMENT BEFORE SENATE BANKING & CURRENCY COMMITTEE
February 20, 1945

REDUCTION IN RESERVE RATIO AND RENEWAL OF AUTHORITY
TO PLEDGE UNITED STATES GOVERNMENT OBLIGATIONS
AS COLLATERAL FOR FEDERAL RESERVE NOTES

The bill under consideration (S.510) would accomplish the following purposes: (1) Extend indefinitely the authority of the Federal Reserve Banks to pledge United States Government securities against Federal Reserve notes issued by the Federal Reserve Agents. Existing authority expires June 30, 1945; and (2) Reduce the requirements of reserves to be held by Federal Reserve Banks from their present level of 40 per cent in gold certificates against Federal Reserve notes in circulation and 35 per cent in gold certificates or lawful money against deposits, to a uniform minimum of 25 per cent in gold certificates against combined note and deposit liabilities.

The need for reducing the high reserve requirements of the Federal Reserve Banks was mentioned by the President in his Budget message transmitted to the Congress on January 3, 1945.

Pledging of United States Government securities against Federal Reserve notes. - In conditions prevailing today, with Federal Reserve notes outstanding in an amount of 21.7 billion dollars and deposit liabilities of the Federal Reserve Banks in an amount of 16.4 billion, it is imperative to extend the power to pledge United States Governments as collateral notes. Without this authority the Federal Reserve Banks would be obligated to engage in a series of operations for the sole purpose of obtaining other assets that would be eligible as collateral for Federal Reserve notes in place of United States Government securities which would not be eligible. They would have to sell a large enough volume of Government securities to make it necessary for banks to borrow as much as 10 billion dollars from the Federal Reserve Banks at this time and possibly as much as 18 billions by the end of the year. The manner in which this would work is that the Reserve banks would sell the securities in the open market; payment for them would take out an equivalent amount of funds from the market, and member banks would have to borrow this amount from the Federal Reserve Banks in order to replenish their reserves. The promissory notes of member banks at the Reserve Banks would be eligible under the law as collateral for Federal Reserve notes. No public interest would be served, but in the process the market for United States Government war obligations would be disrupted at a time when the Treasury must still raise vast sums to finance the war. It is clear that this must not occur and that, therefore, the power to pledge Government securities against Federal Reserve notes must be continued.

In proposing to permit the Reserve Banks to pledge United States Government obligations as collateral for Federal Reserve notes, it is recommended that no time limit be placed on this authorization. In view of the fact that the Federal Reserve Banks' assets, other than gold certificates, consist at present almost entirely of Government securities, most of which were acquired during the war, and the improbability that these Banks will have any considerable volume of other earning assets in the foreseeable future, it would not be in the public interest to have the authority to use United States securities as backing for notes terminate at a pre-determined date.

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Periodic renewal of this authority not only involves delay, unnecessary expenditure of effort for the Congress and the Board, and the necessity of rehearsing the same arguments over and over again, but it also may result in a period of uncertainty which is disturbing to the United States Government security market. Maintenance of stable conditions in this market is essential in view of the dominant role that Government securities have come to play in our financial structure, and this stability has been and must remain indefinitely a primary objective of Federal Reserve policy. Uncertainty about continued eligibility of Government securities as collateral for Federal Reserve notes would have an adverse effect on this stability.

The pledging of Government securities as collateral was first authorized thirteen years ago as an emergency measure at the depth of the depression when the Federal Reserve Banks needed to buy Government securities in order to ease the pressure of debt on member banks and thus create easier credit conditions. The authority has been renewed from time to time. It is apparent that it will have to be renewed for many years to come. It would be far wiser to extend the authority for an indefinite period, the Congress of course always retaining the right to repeal the authority if this should appear to be desirable.

When the collateral provisions for Federal Reserve notes were first formulated there were practically no Government securities in the market, member banks had a large volume of so-called eligible commercial paper, and were expected to borrow on that paper when they required additional reserves or currency. The situation has radically changed since then. There is now an enormous public debt which constitutes a large part of the earning assets of member banks; the total volume of eligible paper has declined, and many banks have practically no such paper. Banks are also reluctant to borrow from the Reserve Banks and, if they should borrow in considerable volume, this would result in a tightening of credit conditions with disturbing effects on the price of Government securities. Furthermore, if they borrowed, they would borrow on their promissory notes secured by Government obligations. Consequently, what would be back of the notes would still be United States Government securities - but with an endorsement by a member bank. Surely an obligation of the United States Government is not improved in credit standing by endorsement of some member bank!

Collateral requirements are not an effective limitation on credit expansion by the Federal Reserve Banks. Open-market operations of these Banks are governed by considerations of the public interest and not of Federal Reserve Bank earnings. When the Reserve Banks purchase United States Government securities they pay for them by deposit credit. Once these deposit liabilities have been incurred the Federal Reserve Banks are obliged to permit their withdrawal in currency. The public demand for currency, in turn, depends on business conditions, activity of trade, the volume of wage payments, the price level, and the extent of the people's

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wish to hold their liquid assets in the form of cash rather than bank deposits or Government securities. Member banks, to avoid insolvency, must permit their customers to withdraw their deposits in currency; Federal Reserve Banks in turn must permit the member banks to obtain the currency by drawing on their balances with the Reserve Banks. Consequently, the Reserve Banks have no choice in the matter because they have no control over the demand for currency. It serves no useful purpose to encumber these unavoidable operations by legal restrictions which inevitably must give way as soon as they would actually restrict.

In any case Federal Reserve notes have a prior lien on all assets of the Federal Reserve Banks and are obligations of the United States Government. Segregation of special assets of the Federal Reserve Banks as collateral for these notes adds nothing to their quality. It is merely an obsolete piece of machinery conceived at a time when conditions were radically different from those that prevail today. By authorizing the pledging of Government securities as collateral for Federal Reserve notes the collateral requirement is extended to practically all the assets of the Reserve Banks and ceases to be an interference with the performance of their duties and the discharge of their responsibilities. This extension should, therefore, be a permanent part of the law.

Reduction of reserve ratio. - Conditions arising out of the war have caused the reserve ratio of Federal Reserve Banks to decline from 91 per cent at the end of 1941, soon after our entry into the war, to 49 per cent at the end of 1944. If developments continue at the rate of recent months the ratio will fall almost to the legal minimum by the end of the present calendar year. If gold export or currency withdrawals or both should be greater than in 1944, the legal minimum will be reached sooner. The following table shows the factors in the situation, together with hypothetical projections through 1945 based on probable trends of currency, deposit, and gold movements.

Federal Reserve Bank	Dec. 31, 1941	Dec. 31, 1944	Projections	
			June 30, 1945	Dec. 31, 1945
	(In billions of dollars)			
Reserves	20.8	18.7	18.2	17.7
Deposits	14.7	16.4	17.4	18.4
F. R. notes outstanding	8.2	21.7	23.7	26.7
Liabilities requiring reserves	22.9	38.1	41.1	45.1
	(Per cent)			
Reserve ratio	90.8	49.0	44.3	39.2

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It will be seen that the decline in the reserve ratio has been due to a reduction in Federal Reserve Bank reserves and to increases in Federal Reserve note and deposit liabilities. Reduction of reserves has reflected the fact that most of this country's exports have been on lend-lease, while our imports have been on a cash basis. Countries that have sold commodities to the United States have not been able to buy goods here, on account of war restrictions, and have either withdrawn or earmarked gold against the time when goods will once more be available for sale.

Growth of Federal Reserve note circulation has been a part of the general expansion of currency which has accompanied war activity in every country in the world. Expansion of both notes and deposits has reflected growth of Government war expenditures, enlargement of national money income, and advancement of payrolls and trade at higher prices. So long as the Federal Reserve Banks continue to do their part, as they surely must, to assist the Treasury in Government financing and in maintaining stable conditions in the market for United States Government securities, these Banks must not be restricted by an arbitrary reserve ratio.

While the reserve ratio for all the Federal Reserve Banks combined is at present still nearly 49 per cent, that is, considerably above the legal minimum, individual Reserve Banks have ratios that are much nearer to the low point required by law. A table is attached showing the reserve position of individual Reserve Banks at selected typical dates. While adjustment in individual Bank ratios is made periodically by changing their participation in the System holdings of United States Government securities, this involves a great deal of unnecessary work in practical operation. Since it is apparent that means must be found to handle the ratio problem, it is highly desirable that action be taken promptly. This would not only allay fears and uncertainties among holders and prospective purchasers of United States Government securities, but would also eliminate the necessity of making frequent and complicated adjustments among the Reserve Banks.

There are several ways to meet the situation, all of which have been carefully considered. One way would be to issue Federal Reserve Bank notes, which require no reserves, in place of Federal Reserve notes; another way would be suspension of reserve requirements by the Board of Governors of the Federal Reserve System, which is authorized by law, and a third way would be a reduction of reserve requirements by the Congress. Other devices, such as issuance of currency by the Treasury, or reduction of member bank reserve requirements, have been reviewed and found to be inadequate or inappropriate. Reduction of the ratio by law, which is proposed in the bill, is the most clear-cut method, as well as the most consistent with the responsibility of the Congress to regulate the country's monetary policy.

Issue of Federal Reserve Bank notes in their present form was authorized by the Emergency Banking Act of March 1933, and the authority will expire when the President declares that the emergency is over. The

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RESERVE RATIO OF EACH FEDERAL RESERVE BANK
on the 15th of the month from July 1944 to February 1945

(Per cent)

Federal Reserve Bank	July 1944	October 1944	January 1945	February 1945
Boston	53.8	43.6	45.4	45.8
New York	50.6	46.4	52.8	50.7
Philadelphia	48.8	48.6	43.8	44.4
Cleveland	52.9	43.3	45.3	43.6
Richmond	57.5	47.6	45.6	46.6
Atlanta	57.0	51.7	52.0	52.1
Chicago	64.7	63.6	49.7	51.7
St. Louis	54.2	58.0	43.3	46.5
Minneapolis	49.6	51.5	44.9	44.8
Kansas City	53.2	45.7	45.0	45.9
Dallas	51.1	46.6	45.5	44.1
San Francisco	66.5	63.8	54.2	51.3
Total	56.0	52.0	49.3	48.8

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need for the lower ratio may continue beyond that date. Furthermore, the difference between Federal Reserve notes and Federal Reserve Bank notes gives rise to misunderstanding, and it would be simpler and less confusing to the public if Federal Reserve currency were all of one kind. It would be best at a time like this to have a Federal Reserve ratio that indicated to the Congress and to the people the amount of gold certificates held by the Reserve Banks against their total deposit and note liabilities of all kinds.

The authority in section 11(c) of the Federal Reserve Act to suspend reserve requirements does not appear to be the best method of meeting the situation, because the power was not designed for a situation like the present which is of indefinite duration. Suspension must be for a period not to exceed thirty days, renewable at intervals of fifteen days. It also requires a penalty in the form of a progressive interest rate, to be determined by the Board, and added to the discount rate of the Federal Reserve Banks. At a time like the present, when discount rate charges must fit into the general rate policy adopted for war financing, this would not be the best procedure.

Consequently the bill provides for a direct reduction of the required ratio. Such an action would be entirely consistent with the changes in conditions which have occurred since the ratio was first established by the Congress. The original purposes of the ratio were (1) to assure adequate resources for the Reserve Banks to meet demands for gold or lawful money by depositors and note holders, (2) to limit the expansion of Federal Reserve Bank credit, and (3) to assure the public that there was at least 40 per cent in gold back of the Federal Reserve notes which were then being introduced for the first time.

The first purpose is no longer compelling since gold redemption is now not permitted for domestic use, and gold can be exported only under license. While the country's aggregate gold reserves are ample to meet any conceivable foreign demand, a reserve ratio high enough to meet possible demands for both domestic and foreign use is no longer appropriate under present conditions. The second purpose -- limitation of Federal Reserve Bank expansion -- is not relevant at a time when expansion by the Reserve Banks is essential to the needs of war finance. Thirdly, confidence in Federal Reserve notes is well established, and whether the amount of gold back of the notes is 40 per cent or 25 per cent makes no practical difference.

War conditions have caused all belligerents to reduce or abolish central bank reserve requirements. Mechanical limitations on the ability of a central banking organization to extend credit must inevitably give way in time of war to the paramount obligation to support the war effort.

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A reduction to 25 per cent is proposed because it would be sufficient for all foreseeable contingencies. It would enable the Reserve Banks to meet such additional demands for currency by the public and for reserve balances by member banks as are likely to occur. The currency supply and the bank deposit structure could nearly double before the legal minimum would be reached.

The bill provides for elimination of the distinction made in the present law between reserves required against notes and against deposits both as to percentage and as to composition of the reserves. Since the two liabilities are interconvertible at the option of the owners, the same requirements should apply to both. The provision in the bill that legal reserves should consist only of gold certificates would also eliminate controversy as to what constitutes lawful money, and whether the Federal Reserve Banks could, if so minded, use their own notes (Federal Reserve notes or Federal Reserve Bank notes) as reserves against their own deposits.

A clean-cut uniform requirement of gold certificate reserves of 25 per cent against both notes and deposits appears to be the best solution of the problem.

In conformity with the proposed reduction of the ratio to 25 per cent the bill decreases proportionately the levels of the ratio at which the imposition of the different penalty rates provided in the law when reserves are suspended would be proscribed.

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