

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

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STATEMENT OF MARRINER S. ECCLES, CHAIRMAN,
BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
BEFORE THE
BANKING AND CURRENCY COMMITTEE OF THE HOUSE OF REPRESENTATIVES

FOR RELEASE UPON DELIVERY

Mr. Chairman and Members of the Committee: In appearing before you today I wish to make clear that I am speaking for the Board of Governors of the Federal Reserve System, an agency of Congress, and I am not undertaking to speak for the Administration or the Presidents of the 12 Federal Reserve Banks.

You have requested me to testify, I take it, as to what might be done in the monetary and credit field to deal with inflationary forces, which have already gone so far as to cause very serious maladjustments within the economy. I am sure this Committee recognizes that a great many factors and forces contributed to the inflationary problem and that there is no easy, simple, or single remedy. As I have previously stated, we are already in the advanced stages of inflation. Correction is overdue, and the longer it is postponed, the more severe will be the inevitable reaction. At best, monetary and credit policy can have only a supplemental influence in any effective treatment of either inflation or deflation.

In the absence of a comprehensive scheme of controls we must continue to put our main reliance on fiscal policy, which is by far the most effective way to deal with the demand side of the equation, while we do everything possible to maintain and increase production. I have previously outlined other steps which I believe should be taken if we are to deal effectively with the basic causes of current inflationary pressures--increased productivity especially of construction labor and longer hours of work; suspension of future demands for wage increases, especially those of organized labor, where wages are the highest; reduction or discontinuance of increases in prices by business in accordance with reasonable earnings; continuation and expansion of the Treasury's savings bond campaign; and legislation giving the Federal Reserve System such authority as may be necessary to restrict further over-all expansion of bank credit. The legislation proposed would give the Federal Reserve System authority to require banks to hold a special reserve which would be in addition to existing regular reserves and might be held in Treasury bills, certificates, or notes, as well as in cash assets.

Need for this authority would be less if appropriate fiscal policies are continued and Congress restores control of consumer installment credit and if stricter appraisals and less liberal credit terms were applied under the Veterans Administration, the FHA, and the Home Loan Bank programs of housing finance. During the next four months there is likely to be little need for the special reserve requirement because of the large amount of Treasury surplus funds, taken from the market through taxes, which will be available to retire bank-held public debt. Then, unless increased powers are granted, we may be exposed to an unbridled expansion of bank credit, because the Reserve System's existing powers, in the face of its newly acquired responsibilities for the Government security market and in the face of a continued inflow of gold, are insufficient to restrain further bank credit expansion. A precautionary grant of increased powers now is necessary to guard against disaster later.

Banking leaders who have already had some opportunity to study the features of the proposed special reserve plan and have arrived at opinions adverse to its adoption, voice this opposition along two lines of argument. On the one hand they affirm that the plan is impractical, socialistic, and unnecessarily drastic. On the other hand they assert that the plan is not strong enough to accomplish its expressed objectives. The contrast between these two lines of argument is striking. They cannot both be correct; the proposed special reserve plan cannot be too drastic and at the same time be altogether inadequate.

The type of authority proposed is neither novel nor revolutionary. A similar authority was provided under the Banking Act of 1935 in the power to raise reserve requirements of member banks to twice the then prevailing statutory level. This power had been entirely utilized by the outbreak of war in immobilizing gold imports of prewar years. During the war, the requirement for banks in New York City and Chicago was reduced from 26 to 20 per cent of net demand deposits in order to relax temporary pressures on the central money markets and to facilitate war financing. Except for the six percentage points of requirement applicable to central reserve city banks, no margin for the further increase in member bank required reserves now exists.

The inflationary dangers inherent in the war emergency were widely recognized in the early phases of the national defense program. In late December 1940 the Federal Reserve Board, the Presidents of the Federal Reserve Banks, and the Federal Advisory Council unanimously joined in a special report to the Congress pointing out the inflationary dangers for the national economy as a whole in the defense effort, and advising that the authority of the Federal Reserve System was inadequate to deal with the existing and potential excess reserve problem of the banks. Accordingly, this special report recommended that Congress-

- (a) Increase the statutory reserve requirements for demand deposits in banks in central reserve cities to 26 per cent; for demand deposits in banks in reserve cities to 20 per cent; for demand deposits in country banks to 14 per cent; and for time deposits in all banks to 6 per cent.
- (b) Empower the Federal Open Market Committee to make further increases of reserve requirements sufficient to absorb excess reserves, subject to the limitation that reserve requirements shall not be increased to more than double the respective percentages specified in paragraph (a).
(The power to change reserve requirements, now vested in the Board of Governors, and the control of open market operations, now vested in the Federal Open Market Committee, should be placed in the same body.)

- (c) Authorize the Federal Open Market Committee to change reserve requirements for central reserve city banks, or for reserve city banks, or for country banks, or for any combination of these three classes.
- (d) Make reserve requirements applicable to all banks receiving demand deposits regardless of whether or not they are members of the Federal Reserve System.

And in addition to these major recommendations, the special report of 1940 urged that the needs of the defense program be financed as far as possible from existing deposits and from tax revenues rather than from inflationary borrowing from the banks.

I bring the report to your attention because at that time all were in favor of increasing the basic reserve requirements of commercial banks. I particularly commend the special report of 1940 to your attention because the power to increase basic reserve requirements is a far more onerous and drastic power than the special reserve plan, which the Board of Governors now proposes. The special reserve plan, however, is identical in purpose to an outright increase in regular reserve requirements. The plan, in fact, is no more than an adaptation of this method of restricting bank credit expansion in a banking situation profoundly altered by war finance and by the huge wartime increase in public debt. The plan would enable the banks to retain the same volume of earning assets they now have, in place of making them reduce earning assets, as would an increase in regular reserve requirements, with adverse effects upon bank earnings.

In its Annual Report for 1945 the Board indicated that there were three alternative methods for dealing with the monetary aspects of the postwar inflationary problem inherent in the postwar banking situation: First, a limitation on the Government bond holdings of banks, second, an increase in their regular reserve requirements, and, third, the holding of short-term Government securities or cash under a special reserve requirement. After exhaustive study of the problem, the Board has selected the special reserve method as the least onerous, the most equitable, and the most practicable method. It has now set forth the detailed specifications of its plan on the basis of minimum needs to meet prospective problems of bank credit expansion.

These specifications provide for the immobilization, even at the maximum, of only a part of existing large holdings by commercial banks of Government securities. They also provide that the special reserve requirement could be imposed only gradually, and that, if inflationary bank credit expansion can be otherwise brought under check, the requirement would not be imposed at all. Under the plan suggested, the individual

banker would be left in the same competitive position he is in today. Contrary to what has been stated by the National City Bank Letter and others, banks would not be under legal compulsion to buy Government bonds; the holding of Government securities in lieu of cash or balances with other banks to meet the special reserve requirement would be entirely optional with the individual bank.

The Board's special reserve plan is a middle of the road proposal for helping to deal with the credit and monetary aspects of the difficult and complex inflationary situation. The Board feels, however, that the purpose of restraining further inflationary expansion of bank credit can be adequately accomplished by the specifications it has drawn for the plan, if its use is accompanied by appropriate fiscal and other policies. It would seem that the bankers would prefer the new proposal to an increase in regular reserve requirements, which they recommended for adoption in 1940 to deal with anticipated inflationary dangers.

The Board recognizes that the proposal is no panacea, but it would be an important restraint available to be used, and to be used only, in the event of continued inflationary banking developments. The Board further recognizes that it would have been better to have had the power available for use earlier. Had the Federal Reserve System been given the additional power that was recommended in 1940, it would no doubt have used it already in view of developments during and since the war.

It would seem desirable to have the special reserve authority available now to restrain inflationary credit expansion, should its use become necessary, than to wait until further expansion has developed. The further the inflation goes, the more difficult and sensitive the situation becomes, the greater is the resistance to measures that would accomplish some restraint, and the more delicate is the task of applying such measures. If some particular measure of restraint is involved at a critical period, it might be considered by the public to be responsible for bringing about the downturn, even though the downturn would have happened in any case.

I can well understand the feeling of some within the Reserve System that the System will be held responsible for deflation if the use of this requirement should coincide with a deflationary readjustment. It is because of this possibility that the Board would be glad not to have the grave responsibility for using this authority. The System is not desirous of assuming the onus of bringing on a deflation. Nevertheless, the Board feels that the System should not shrink from bearing its share of responsibility for restraint on further inflationary developments in the credit field.

For some months the Reserve System and the Treasury have been actively cooperating in a program combining monetary, fiscal, and debt-management restraint on current inflationary bank credit expansion. Some moderate, corrective rise has been permitted in wartime levels of interest

rates on short-term Government securities, together with some adjustment in yields on long-term issues from very low levels. In addition, excess funds in Treasury balances arising from current budget surpluses have been applied to the retirement of maturing bank-held Government securities.

The System has also urged all banks to maintain conservative standards in the extension of consumer instalment credit, and has joined with other Federal and State bank supervisory agencies in urging all banks to confine bank credits to financing that will help production rather than merely increase consumer demand.

This modest program of restraint adopted in October by the Federal Open Market Committee and accepted by the Treasury, together with other policies followed since early in 1946, has reversed the processes that contributed so strongly to the wartime expansion of bank credit. The System will continue to carry out this program as long and as vigorously as possible. The proposed special reserve plan is not designed as a substitute for this program, but would supplement and reinforce it. The plan would not, of course, be used if this modest program proves to be sufficiently effective.

Over the next four months, the use of the suggested special reserve would not be necessary because of the large amount of Treasury surplus funds taken from the market in taxes, which will be available to retire bank-held public debt. This retirement would temporarily exert pressure against bank credit expansion. At the same time it must be recognized that present forces of credit expansion are very strong indeed. Despite the pressures of fiscal policy during September and October, which drew upon bank deposits and permitted the retirement of over one billion dollars of Government securities held by the banking system, deposits of businesses and individuals at commercial banks increased by 2.5 billion dollars, reflecting largely extension of bank loans to businesses, consumers and owners of real estate. Current reports indicate that the expansion of credit to these groups of bank customers continues to be at an unduly rapid rate.

The Federal Reserve Board wants it understood that it is not pressing for the enactment of the proposed special reserve requirement. The Board is an agent of Congress and its responsibility, even though at times an unpopular responsibility, is to point out to Congress the dangers which it sees in the existing bank credit and monetary situation. The Board further wishes to point out that, in the event of continuing rapid expansion in the total volume of bank credit, the alternative to the proposal or some other more onerous and restrictive program would be a substantial increase in discount rates and withdrawal of the Reserve System's support from the Government securities market. A final alternative is simply to let inflation run its course.

It is our opinion that the present discussions of the banking and monetary problem in Congress, in the public press, and in banking councils are having a beneficial influence. As a result of these

discussions, bankers throughout the country are gaining a better understanding of the current inflation situation and of the relation of their banking policies to inflation. It may well be that the perspective thus gained on the national problem and on the relationship of the individual bank to it will encourage a voluntary program of restraint on the part of many bankers. If such self-restraint is sufficiently effective to avoid further over-all expansion of bank credit, then the purpose of the special reserve plan will have been met. The bankers as individuals cannot be blamed for causing the present inflationary spiral although their operations as a system have made it possible. However, in the future if there is further over-all expansion of bank credit and the bankers resist any restraint on such expansion, there would be some justification in assigning some blame to them for the contribution of bank credit expansion to continued inflationary developments.

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I should like now to present for the information of your Committee a summary description of the proposed special reserve plan. You have been given copies of a statement which presents a detailed description. This statement is necessarily technical at some points because the effort has been made to make the explanation in all respects complete, and to answer every technical question that might be raised about the plan, its operation, and its banking effects. With your permission, I will omit those passages that impress me as needlessly detailed and technical for purposes of today's discussion. The complete statement will be included in the printed record.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
Washington, D. C., December 5, 1947

PROPOSAL FOR A SPECIAL RESERVE REQUIREMENT AGAINST
THE DEMAND AND TIME DEPOSITS OF BANKS

In order to provide a more effective means of restraining inflationary expansion of bank credit, the Board of Governors of the Federal Reserve System proposes that Congress pass legislation granting the System's Federal Open Market Committee temporary authority to impose gradually as conditions may warrant a requirement that all commercial banks hold a special reserve. This reserve should be in addition to reserves required under existing laws. It should be calculated, within limits fixed by law, as a percentage of demand and time deposits and should consist of Treasury bills, certificates, or notes, balances with Federal Reserve Banks, cash or cash items, or interbank balances.

Need for the Special Reserve Requirement

This special requirement would make it possible for the Federal Reserve System to immobilize a portion of these assets. This immobilization, however, would be only for the purpose of preventing their use for the purpose of obtaining additional reserves to support expansion of credit to private borrowers. Moreover, as gold acquisitions create bank reserves, they could be offset by an equivalent increase in the special requirement. The additional requirements would also reduce the possible multiple expansion of bank credit on the basis of any increase in reserves.

At present high levels of employment and output, further expansion of the total volume of bank credit is inflationary because it would increase the active demand for goods and services, which is already in excess of the productive capacity of this country's existing industrial structure and labor force.

So long as the public debt is as dominant a part of the country's financial structure as it is at present the Federal Reserve System has a responsibility for maintaining orderly conditions in the U. S. Government security market. In practice this means that the System stands ready to purchase Government securities offered for sale if they are not taken by other purchasers. Whenever the Federal Reserve buys Government securities, additional bank reserves are created and these in turn supply the basis for an expansion of bank credit of more than six times the amount of the reserves.

Ability of banks to increase reserves.--Commercial banks currently hold about 70 billion dollars of Government securities. As is shown in the chart, this sum exceeds their prewar holdings by more than 50 billion dollars and is about three-fifths of total loans and investments. In addition to this great expansion in holdings of Government securities,

commercial banks also have increased their loans and holdings of other securities. Transfer of any part of these Government securities to the Federal Reserve Banks creates reserves on which a sixfold expansion of credit can be built. The potential inflationary expansion of the money supply is thus enormous. Reserves arising from gold acquisitions or Federal Reserve purchases of securities from nonbank investors may add still more to this potential.

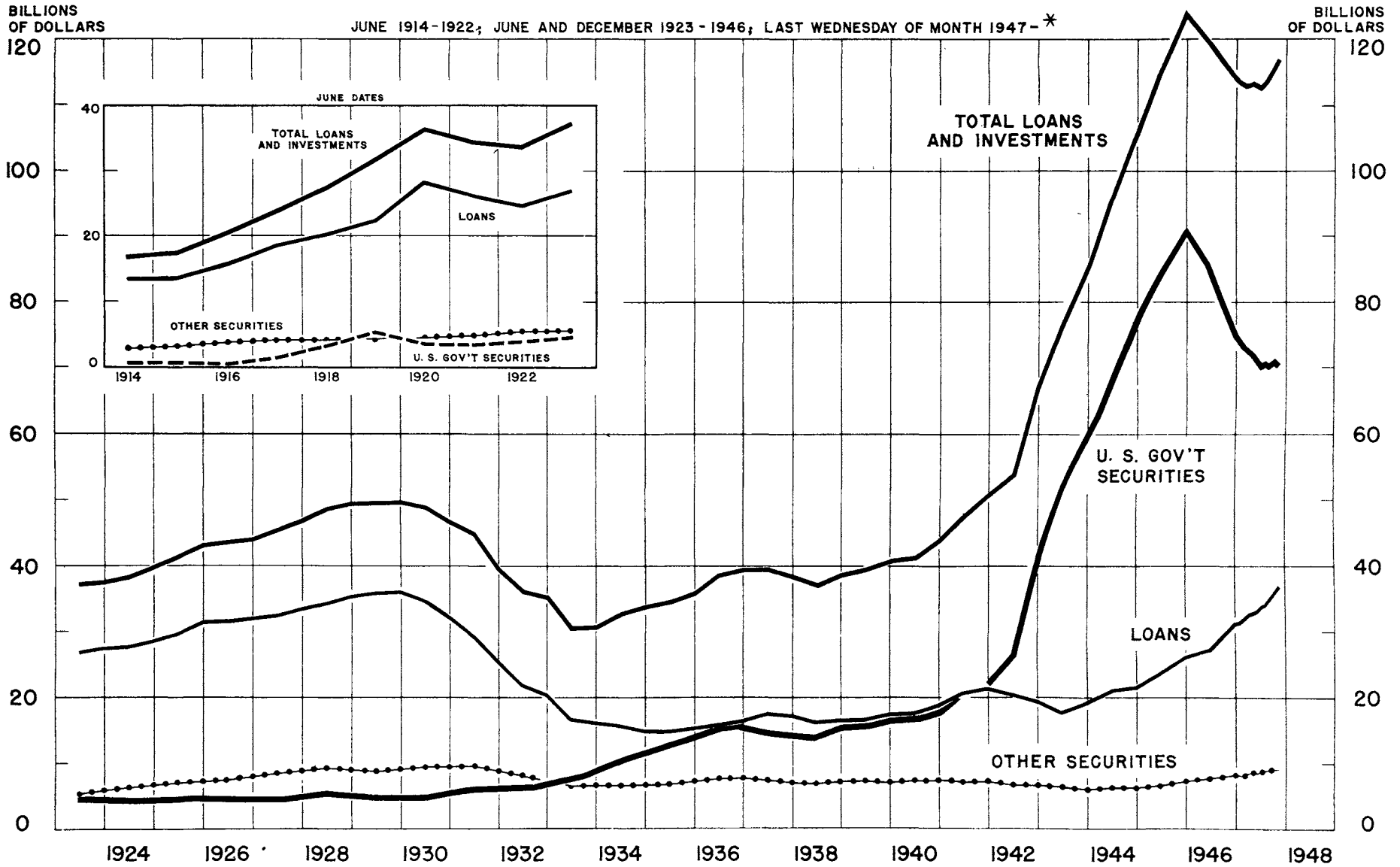
The opportunity which the banks now have to create new reserves on their own initiative by selling Government securities to the Federal Reserve System is not a long-established right, but is one of the heritages of war finance. In wartime the Federal Reserve System was under obligation to provide banks with sufficient funds to purchase Government securities in excess of those sold to nonbank investors. After the war, the necessity of providing a stable and orderly market for the vast public debt outstanding has in effect made the Federal Reserve System the ultimate or residual market for Government securities. So long as this situation continues and the banks are free to use their Government securities to obtain reserves at will there is no effective restraint on bank credit expansion.

Prior to the war, the ability of banks to expand credit was limited by the existing supply of bank reserves, which was largely subject to Federal Reserve control. Except during the period of large gold inflow which brought an excessive volume of reserves, the available supply of bank reserves was determined principally by the volume of member bank borrowing from the Reserve Banks or by Federal Reserve purchases and sales of bills and securities in the open market. These open market operations were definitely regulated in amount so as to provide the supply of reserves required by the economy. Variations in prices and yields on Government securities were an incidental result of these policies.

Need for Federal Reserve support of Government securities market.--Under present conditions large-scale and continuous Federal Reserve open market operations are essential to the maintenance of an orderly and relatively stable market for Government securities and are a necessary adjunct of the Treasury's program for managing the economy's huge public debt of 260 billion dollars. The System often purchases and sells securities amounting to hundreds of millions of dollars in a week. In October and November System purchases totaled 3.2 billion dollars, sales 1.2 billion, redemptions of maturing issues 2.1 billion, and exchanges of maturing for new issues 8.2 billion. Large-scale Federal Reserve transactions are at times essential for the maintenance of a market for Government securities. In view of the System's greatly enlarged responsibilities for the Government securities market and in view of the volume of such securities now held by banks, the System no longer has adequate power to influence the potential volume of bank credit in the way it could before the war.

It is illuminating to know the extent to which public debt has become a dominant factor in the country's financial structure. The United States Government debt, which was never more than a third of private and other debt before 1941, is now one and a half times the

LOANS AND INVESTMENTS OF ALL COMMERCIAL BANKS



BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

* FEDERAL RESERVE ESTIMATES.

remaining debt. That part of the public debt which is marketable amounts to 167 billion dollars, compared with 69 billion of stocks and 15 billion of non-Government bonds listed on the New York Stock Exchange and an estimated 13 billion of marketable securities listed on other stock exchanges throughout the country.

Today, Government securities are widely held as liquid investments which can be readily sold and, therefore, transactions in them are likely to be frequent. This liquidity rests in considerable part on having the Federal Reserve System provide a residual, assured market for purchase and sale of Government securities.

In these circumstances, it would be entirely inadequate for the Federal Reserve System merely to revert to the prewar practice of purchasing and selling only definite amounts of securities, determined solely on the basis of the economy's need for bank credit or for the purpose of offsetting the effects of gold or currency movements on bank credit. The System needs to take into account, in addition to other factors, conditions affecting the Government security market. Traditional actions through discount rate policy are largely irrelevant, because the banks have little or no occasion to borrow funds to maintain reserve positions so long as they can sell Government securities for this purpose.

Since the Reserve System has to engage in constant buying and selling of U. S. Government securities on a large scale, the prices or rates at which these transactions are effected are necessarily determined by the System. In fact, under present conditions, the structure and level of interest rates on Government securities which the System helps to maintain in the market have become the principal expression of Federal Reserve policy instead of the volume of purchases and sales.

Limited effectiveness of increase in rates on Government securities.--Control of interest rates on Government securities, however, is not an effective instrument for achieving monetary objectives. A moderate rise in yields on Government securities will not prevent, and will only slightly restrain, banks from selling securities in order to make loans. An increase in rates large enough to exercise real restraint on banks would generally be too great or too abrupt to be consistent with the maintenance of stable conditions in the market. Even an intimation that such a policy might be followed may lead to a flood of selling. The System might find itself under the necessity to support the market and in the process might create more reserves than it would have created through meeting the demands of banks in an orderly market. This is the postwar monetary paradox.

Purpose of special reserve.--The special reserve proposal is designed to place some restriction on the newly-acquired privilege of banks to obtain at will more reserves on which to make more and more loans.

It is not, as has been asserted by some of its critics, a revolutionary device to compel banks to hold Government securities. The proposal contains no such compulsion. If any bank chooses to hold the special reserve in cash or on deposit with another bank or with a Reserve Bank it would be free to do so. At the same time the proposed measure would not require banks to reduce their holdings of Government securities.

The proposal would give the Federal Reserve System no new power to interfere with bankers in running their own banks but it would restore to the System some of its previously-held authority to exercise regulatory power over the available supply of bank reserves. There is nothing new or revolutionary in that.

Under the proposed authority it would be possible to insulate a part of the Government securities market from private credit and permit the Federal Reserve System to use open market operations and discount rates more freely to affect conditions in the private credit market. Thus, the authority would make it possible to limit the volume and raise the cost of private credit without necessarily increasing the interest cost to the Government on an important part of the large public debt outstanding.

Features of the Special Reserve Plan

Special features of the proposed temporary authority may be briefly summarized as follows:

- (1) Banks subject to the provisions would be required, in addition to their regular reserves, to hold a special reserve consisting of:
 - (a) Obligations of the United States in the form of Treasury bills, certificates and notes (with original maturities of 2 years or less);
 - or
 - (b) Cash items, as defined in the next paragraph, to the extent that their total exceeds 20 per cent of gross demand deposits plus 6 per cent of time deposits.
- (2) For this purpose cash items would include the following:
 - (a) Balances with Reserve Banks, including statutory required reserves.
 - (b) Coin and currency.
 - (c) Cash items in process of collection.
 - (d) Balances due from in excess of balances due to banks in United States.
- (3) The special reserve requirement would apply to both demand and time deposits and would be subject to a maximum limit fixed by statute. A maximum of 25 per cent of gross demand deposits and a maximum of 10 per cent of time deposits will probably be adequate for the temporary period covered by the proposed statute.

- (4) The requirement would apply to all banks receiving demand deposits, including member banks of the Federal Reserve System and nonmember banks--insured and noninsured. It would not apply, however, to banks that do exclusively a savings business.
- (5) The power to impose and to vary the special reserve requirement would be vested in the Federal Open Market Committee and would be limited by law to a temporary period of three years.
- (6) The requirement would be introduced gradually as credit conditions warrant. The authorizing statute could provide that, after a special reserve has been established of 10 per cent against gross demand deposits and 4 per cent against time deposits, further changes would not exceed 5 per cent of gross demand deposits and 2 per cent of time deposits at one time. Ample notice should be given before the effective date of the initial application of the requirement, or of subsequent changes, to allow banks adequate time to make adjustments.
- (7) The following considerations should determine the timing of the introduction of, or changes in, the special reserve requirement:
 - (a) The volume and ownership of special reserve assets and of other assets readily convertible into eligible assets;
 - (b) Past and prospective gold movements, currency fluctuations, or other factors causing changes in the volume of bank reserves;
 - (c) Conditions in the Government securities market;
 - (d) The general credit situation.
- (8) Special reserves and requirements would be computed on a daily average basis for monthly periods, or for other periods by classes of banks as the Open Market Committee might prescribe. The penalty against average deficiencies in the requirement would be one-half per cent per month, payable to the United States.
- (9) The Federal Open Market Committee would be authorized to issue regulations governing the administration of the requirement, to require necessary reports, and to delegate administration with respect to nonmember banks to other appropriate Federal or State banking agencies.

Operation of the Proposal

Establishment of the special reserve requirement would accomplish two principal purposes: (1) it would reduce the amount of Government securities that banks would be willing to sell to obtain additional reserves; and (2) it would decrease the ratio of multiple credit expansion on the basis of a given amount of reserves. These results could be accomplished without reducing the volume of earning assets of banks.

Reduced availability of secondary reserve assets.--The special reserve requirement would not deprive banks of any earning assets but would reduce the available amount of highly liquid and readily salable assets which banks hold as secondary reserves to meet losses of deposits and new credit demands. Because of the reduction in these operating secondary reserves, banks would be less willing to sell Government securities held in excess of the requirement in order to acquire higher-yielding loan or investment assets. Thus, an effect of the special reserve requirement would be to reduce the creation of new reserves and expansion of bank credit through sale of Government securities to the Federal Reserve.

Lower multiple-expansion ratio.--Reduction in the ratio of multiple credit expansion on the basis of any addition to the supply of reserves would be an important effect of the special reserve requirement. How great a reduction from the present ratio of six or more to one would result from the proposal will depend on the percentage requirement established. It would also depend on the banks' holdings of assets eligible for the special reserve and their ability to acquire them from sources other than the Federal Reserve. It is not feasible to estimate the extent of the reduction in the ratio--but under present conditions--with the easiest source of the needed reserve material being the Federal Reserve Banks--the ratio, at the maximum required rate of special reserve, may conceivably decline from the present figure of 6 to as low as 2-1/2.

Influence of existence of power to impose requirement.--The existence of power to impose a special reserve requirement would itself exert a strong restraining influence on bank credit expansion. Banks would need to guide their policies with an eye to the possible imposition of the requirement. The extent of use of the special reserve requirement would necessarily depend on developments in the general credit situation.

Reinforcement of other instruments of credit regulation.--Other instruments of Federal Reserve policy could be so used as to facilitate adjustment to the new requirement and subsequently would be employed to apply such additional restrictions or such easing as the general credit situation might require. From the monetary point of view the principal purpose of the proposed new requirement is to make possible the more effective use of the existing instruments in offsetting changes in bank reserves--particularly open market operations and discount rates--without seriously upsetting the Government securities market and unduly raising the interest cost on the public debt.

The Federal Open Market Committee, which would have authority to apply and vary the requirement, is composed of all seven members of the Board of Governors of the Federal Reserve System and five representatives of the Federal Reserve Banks. The Committee's present authority covers the System's Government security and other open market operations. The use of the proposed special reserve requirement would be closely related to these operations.

Bank lending for essential needs not prevented.--Restrictions on further bank credit expansion by the proposed requirement, supplemented as the situation may warrant by other credit control measures, would not prevent the accommodation by banks of the economy's essential credit needs. The additional reserve requirement, however, would put the banks under pressure to attempt to meet essential credit demands out of existing loanable funds. To expand loans, banks would need to sell securities of types that might be bought by other investors, rather than short-term Government securities which under present conditions are purchased principally by the Reserve Banks.

Advantages of the Proposal

Rise in interest rates largely limited to private credit.--The proposed measure has many important advantages over alternative means of curbing credit expansion. It is frequently suggested that restraint on further bank credit expansion could be accomplished by allowing short-term interest rates, both on public and on private credit, to rise substantially, thus increasing the cost of borrowing and thereby seeking to deter borrowing. It is doubtful that such a policy would effectively deter borrowing, and, in any event, it would greatly increase the cost to the Government of carrying the public debt and might have disruptive effects on the Government securities market. Under the proposed authority, interest on private credit could be raised without increasing rates on Government securities. In other words, the higher rates would be paid by those who are currently engaged in inflationary borrowing and who might be deterred by them. These rates would not be paid by the Government, which is reducing its indebtedness.

Restraint on lender.--Restriction of inflationary expansion of total bank credit to private borrowers can be more effective if the restraint is placed primarily on the lender. Under present conditions, even such a substantial rise in short-term interest rates as one or two percentage points would not deter many borrowers, and might encourage further lending because of the additional profit inducement to the lender. Under the proposed measure, the restraint is placed primarily upon the lender, that is, the banking system. By limiting the ability of the banks to make credit available, the proposal would thus be a retarding influence on further bank credit expansion. As already stated, banks would not only charge more for loans they make to private borrowers but would be more cautious in extending such loans. The latter may be a more important restraint than the former. Higher rates are not an effective deterrent in boom conditions but difficulty in obtaining credit is a powerful restraining influence.

Preferable to increase in regular reserve requirements.--It has been suggested that the same result might be achieved by an increase in existing basic reserve requirements of banks. If this were done, however, banks would have to meet the increase by selling Government securities, which the Federal Reserve System would have to buy in order to supply the needed reserves. This would decrease the banks' earning assets and their earnings, whereas the proposed special reserve measure would enable them to retain earning assets. The continued profitability of bank operations is essential if the banks are to meet their increasing costs and build up adequate reserves while serving their communities constructively.

To increase primary reserve requirements would also raise difficult jurisdictional, legal, and administrative problems with reference to non-member banks, whereas the specific form of the proposed special reserve requirement, as more fully described in the next section, is designed to fit the sort of banking system that exists in this country without alterations in its structure or drastic changes in its customary methods of operation.

Banks that are not members of the Federal Reserve System would have to be included. Limitation of the requirement to member banks only would seriously weaken the Federal Reserve System by giving a great advantage to nonmembership and therefore would make the measure ineffective, as well as inequitable. The new measure, as proposed, would assure equitable treatment of individual banks and groups of banks without requiring that all banks become subject to a single authority. The proposed requirement would also make use of the practice of interbank deposits without interfering with the system of correspondent relations.

In summary, the proposal would require banks to hold a large portion of the Government securities which they were encouraged and permitted to buy to aid in war finance and still allow them to meet all essential credit needs of the economy. It would assure the maintenance of a high degree of liquidity and safety in the banking system during a period of rapid and uncertain economic change. It would not necessitate changes in existing banking structure or procedures.

The Board believes that the proposed plan is the most effective and practical method of dealing with the present monetary and credit situation because it assures that the pressures will be exerted at the places where restraint on bank credit expansion is needed, namely, in the field of private loans. At the same time the plan will protect the interests of the Government, the general public, and the banking system.

Formula for Computing the Special Reserve Requirement

As explained earlier, the special reserve requirement might be placed as high as 25 per cent of demand deposits and 10 per cent of time deposits or at some lower level. The assets that would be counted as special reserves include Treasury bills, certificates of indebtedness, and notes having original maturities not exceeding two years, as well as certain specified nonearning or cash assets in excess of 20 per cent of demand deposits and 6 per cent of time deposits. This deduction makes a uniform allowance for required regular reserves and other customary operating funds of banks. Computation of the formula is illustrated in Table 1 attached.

Reasons for selection of Government securities to be included in special reserve -- Only Treasury bills, certificates, and short-term notes are proposed for inclusion in the special reserve and other Government securities are eliminated for a number of reasons. The volume of bills, certificates, and notes can be more easily limited to relatively stable amounts. Inclusion of Government bonds within one or two years of maturity or call dates would result in wider variability in the total outstanding amount of eligible reserve assets. To include all Government securities would make necessary a very high reserve requirement in order to be an effective restraint. Since banks holding deposits subject to withdrawal

on demand or short notice should maintain a high degree of liquidity, securities which are short term at issuance are more appropriate assets for them to hold as reserves.

The inclusion of longer-term, higher-rate securities in the formula would make it possible for banks to continue to shift their lower-rate issues to the Federal Reserve and to purchase higher-rate bonds in the market. Unless requirements were very high most banks would have an excess of special reserve assets and could sell short-term securities to the Reserve System. Limitation of the requirement to bills, certificates, and notes with low coupon rates would make it necessary for banks to sell their higher-rate issues in order to expand loans. This would be more of a discouragement to lending than sale of low-rate, short-term issues and also the higher-rate issues would be bought more readily by others than the Federal Reserve. Finally, the limitation would improve the market demand for reserve-eligible issues and help to maintain a lower rate on short-term Government borrowing without lowering long-term interest rates, which are an important source of income for investors of savings.

Reasons for including cash assets.--The proposed eligible cash assets include balances with the Federal Reserve Banks, coin and currency, cash items in process of collection, and balances due from, in excess of balances due to, other banks in the United States. However, only the excess of the sum of these items over an amount needed for required reserves and other customary operating funds customarily held by banks would be counted in the special reserve. A level of 20 per cent of gross demand deposits, and 6 per cent of time deposits, uniform for all banks, is proposed as an equitable statutory amount for these customary operating funds. What the banks hold above this amount will be eligible to count as special reserves. Banks of all classes typically hold these cash items in an aggregate amount equal to the sum of about 25 per cent of gross demand deposits and 6 per cent of time deposits.

Provision in the formula for some margin of cash assets, as well as the specified short-term Government securities, is desirable to accomplish the purposes of the special reserve authority. Confining the eligible special reserve assets to Government securities would cause difficulties to banks obtaining new funds and not holding adequate amounts of the required securities; they should be permitted to count their cash as reserves until they could acquire, or in case they could not acquire, Treasury bills, certificates, or notes. Banks ought not to be compelled to buy such short-term securities in order to meet the proposed special reserve requirement, if for operating reasons they prefer to hold excess cash assets. Cash holdings, moreover, are even more effective in meeting the purposes of the requirement. From the standpoint of avoiding credit expansion, a formula limited to short-term Government securities would be less effective than one which includes cash in the special reserve.

Allowance for differences in banking laws and procedures.--An equitable formula should allow for the great variations that exist among groups of banks with respect to basic reserve requirements and with respect

to holdings of different types of cash assets, without interfering unduly with these requirements and practices. If the requirement were limited to member banks, only excess reserve balances at Federal Reserve Banks and the specified Government securities might be allowed to count as special reserves. Reserve requirements for nonmember banks, however, not only differ from those for member banks but also vary from State to State. For nonmember State banks, balances due from banks constitute the major part of reserves required by State law, and the excess of such balances over statutory requirements comprise other operating funds, or secondary reserves. Member banks hold their required reserves, and perhaps some excess, on balances with the Federal Reserve Banks, but member banks also hold balances with correspondent banks as part of their operating or secondary reserve funds. Both nonmember and member banks would undoubtedly prefer to continue the practice of holding part of their operating funds as balances due from other banks.

Permitting banks to count all of their balances due from other banks in cash items eligible as special reserve assets would present an opportunity for building up fictitious reserves through the pyramiding of interbank balances by multiple exchange of deposits among banks. To prevent such a development, insofar as practicable, the special reserve plan would permit balances due from other banks to be counted as eligible assets only to the extent that they exceed balances due to other banks. Any other treatment of interbank deposits would invite evasion and jeopardize the objectives of the plan.

The proposed formula for the computation of cash assets eligible for satisfying the special reserve requirement treats member and nonmember banks alike, insofar as differences in practices and laws permit. It avoids interference with established correspondent relations, and, in fact, makes use of these relations. In the interests of administrative simplicity, the proposed formula is uniform for all banks.

Availability of Special Reserve Assets

The formula and its application to certain broad groups of insured banks, using aggregate figures as of June 30, 1947, is illustrated in Table 1 attached.

Differences by groups of banks.--The table shows that banks in each major group have an excess of cash assets over the minimum allowance and also have more than enough special reserve assets available to meet a requirement established at 10 per cent against gross demand deposits and 4 per cent against time deposits. At the statutory maximum suggested for the requirement--namely 25 per cent against demand deposits and 10 per cent against time deposits--the different groups show deficiencies in holdings of eligible assets of varying percentage amounts. New York City banks held the smallest amounts of eligible assets relative to their deposits, while country member and nonmember banks held the largest amounts.

The variation in the percentages of deficiency or excess in special reserve assets at the selected levels is still wider, of course, when studied by groups of banks according to Federal Reserve Districts. This point is illustrated in Table 2 attached, which is also based on figures for June 30, 1947. Each group in each district would be able to meet the lower level of requirements used. Data for individual banks would show even greater differences than appear for the groups of banks in Table 2, and some banks might have deficiencies in holdings of eligible assets even at the lower requirement level.

Adequate supply of special-reserve and other liquid assets.--

In considering the deficiencies in eligible special reserve assets that banks might confront at certain requirement levels, it must be remembered that banks hold substantial amounts of short-term Government bonds that may eventually be refunded by the Treasury into eligible assets or that could be converted through the market into such assets. In general the Federal Reserve would purchase the bonds and sell banks reserve-eligible securities. Holdings of short-term bonds as percentages of gross demand deposits at mid-1947 are also shown in Table 2.

According to figures relating to the ownership of the public debt on September 30, 1947, shown in Table 3 attached, all commercial banks hold about 15 billion dollars of Treasury bills, certificates, and notes,* and in addition 6 billion of bonds due or callable within one year and 30 billion of bonds within one to five years. These holdings were widely distributed among individual banks. As these bonds mature or are called they may be refunded by the Treasury through issuance of securities eligible to be held as special reserves. The amount of Treasury bills, certificates, and notes issued can be made to depend on the need of the banking system and the demand for such assets.

As Table 3 indicates, moreover, the Federal Reserve System holds 22 billion dollars of Treasury bills, certificates, and notes, which banks could acquire by selling to the System other Government securities. About 12 billion dollars of eligible obligations are also held by nonbank investors, and these might be bought by banks. Thus the total of Treasury bills, certificates, and notes outstanding is nearly 50 billion, compared with gross demand deposits at commercial banks of 100 billion. The amount of such securities outstanding may be decreased through debt retirement or increased through refunding of bonds. It is estimated that, after allowing for probable reduction in total marketable debt and for refunding of all other retired issues into reserve-eligible securities, the total amount of such securities outstanding will continue fairly close to the present level for the next three years. The amounts held by banks may be increased by purchases from other holders.

Thus banks could readily obtain enough bills, certificates, and notes to meet a special reserve requirement of 25 per cent. They could still hold substantial amounts of short-term securities as secondary reserves free for operating purposes, but the amount of such freely available funds could be materially reduced by the requirement.

* For simplicity of computation these figures include some notes which had original maturities of over 2 years and therefore would not be eligible as special reserve assets under the proposal. These, however, mature shortly and in any event could be readily shifted into reserve-eligible securities.

TABLE 1

ILLUSTRATIVE COMPUTATION OF SPECIAL RESERVE ASSETS, JUNE 30, 1947
 (Based on aggregate figures in millions of dollars, by groups of banks)

Assets	Member banks				Nonmember insured banks
	Central reserve city		Reserve city	Country	
	New York	Chicago			
1. Gross demand deposits	22,683	5,037	31,983	27,659	11,891
2. Time deposits	1,459	871	11,269	14,475	6,449
3. Coin and currency	123	36	470	780	395
4. Cash items in process of collection	1,884	349	2,623	854	124
5. Excess of demand balances due from over demand deposits due to other banks in U. S.*	--	--	--	2,546	2,765
6. Balances with Federal Reserve Banks	4,166	973	6,274	4,628	--
7. Net cash assets* (3 + 4 + 5 + 6)	6,173	1,357	9,367	8,787	3,284
8. Deduct 20% of gross demand deposits plus 6% of time deposits	4,624	1,060	7,073	6,400	2,759
9. Excess cash assets* (7 - 8)	1,549	298	2,294	2,387	525
10. Treasury bills, certificates, and notes	2,015	606	4,874	5,191	2,932
11. Total special reserve assets* (9 + 10)	3,564	904	7,168	7,578	3,457
12. Special reserve required at given percentages:					
a. 10% against demand and 4% against time deposits	2,327	539	3,649	3,345	1,443
b. Maximum of 25% against demand and 10% against time deposits	5,817	1,346	9,123	8,362	3,608
13. Deficiency or excess of special reserve assets:*					
a. With 10% against demand and 4% against time deposits	+1,237	+365	+3,519	+4,234	+2,014
b. With 25% against demand and 10% against time deposits	-2,259	-443	-1,954	-784	-151
14. Percentage deficiency or excess of special reserve assets to demand deposits:					
a. With 10% against demand and 4% against time deposits	+5.5	+7.2	+11.0	+15.3	+16.9
b. With 25% against demand and 10% against time deposits	-9.9	-8.8	-6.1	-2.8	-1.3

* Figures shown for these items are computed on the basis of aggregates by groups of banks for the country as a whole; totals of figures computed separately for individual banks or from aggregates by districts would show somewhat different amounts of available cash assets for some of the groups.

TABLE 2
RATIOS OF AVAILABLE SPECIAL RESERVE ASSETS AND SHORT-TERM TREASURY BONDS
TO GROSS DEMAND DEPOSITS, ALL INSURED COMMERCIAL BANKS, JUNE 30, 1947

	Percentage of gross demand deposits						
	Treasury bills, certificates, and notes	Excess cash assets ^{a/}	Total special reserve assets	Deficiency or excess of special reserve assets if requirements are		Treasury bonds due or callable ^{b/}	
				25% of demand and 10% of time deposits	10% of demand and 4% of time deposits	Within 1 year	Within 1-5 years
<u>Central reserve city member banks</u>							
New York	8.9	6.8	15.7	- 9.9	+ 5.5	5.7	27.8
Chicago	12.0	5.9	17.9	- 8.8	+ 7.2	4.2	23.4
<u>Reserve city member banks</u>							
Boston	10.3	7.1	17.5	- 8.6	+ 7.1	5.1	18.3
New York	9.3	9.4	18.7	-11.8	+ 6.5	3.5	31.7
Philadelphia	6.7	8.3	14.9	-11.3	+ 4.4	1.5	22.6
Cleveland	8.0	6.4	14.4	-14.2	+ 3.0	7.1	33.7
Richmond	12.9	7.4	20.3	- 7.0	+ 9.4	2.5	32.5
Atlanta	14.4	8.7	23.2	- 3.9	+12.3	3.5	20.0
Chicago	20.6	7.1	27.7	- 2.7	+15.5	5.9	36.9
St. Louis	10.3	6.3	16.6	-10.2	+ 5.9	5.1	24.2
Minneapolis	8.8	7.3	16.1	-10.7	+ 5.4	3.7	28.0
Kansas City	16.8	6.0	22.7	- 3.7	+12.2	4.8	19.1
Dallas	13.3	6.1	19.4	- 7.1	+ 8.8	2.2	18.4
San Francisco	22.9	7.6	30.5	- .9	+17.9	6.1	31.3
Total	15.2	7.2	22.4	- 6.1	+11.0	4.9	27.8
<u>Country member banks</u>							
Boston	12.6	6.4	18.9	-11.1	+ 6.9	5.0	37.3
New York	12.7	9.3	21.9	-11.5	+ 8.6	4.3	45.7
Philadelphia	18.7	10.1	28.8	- 4.4	+15.5	5.0	41.4
Cleveland	17.8	11.1	28.9	- 3.5	+15.9	4.8	40.2
Richmond	17.0	8.5	25.5	- 3.9	+13.8	4.3	31.8
Atlanta	19.7	5.1	24.8	- 3.3	+13.6	3.9	25.0
Chicago	21.6	10.5	32.1	+ .6	+19.5	5.9	41.8
St. Louis	21.7	3.8	25.5	- 3.2	+14.0	4.0	28.7
Minneapolis	23.8	6.4	30.2	- .3	+18.0	7.3	39.8
Kansas City	26.1	9.6	35.8	+ 9.3	+25.2	3.2	18.8
Dallas	21.3	11.1	32.4	+ 6.6	+22.1	2.9	16.7
San Francisco	17.6	7.9	25.5	- 4.9	+13.3	6.9	33.9
Total	18.8	8.6	27.4	- 2.8	+15.3	4.7	34.3

(Continued on next page)

TABLE 2 (Continued)

RATIOS OF AVAILABLE SPECIAL RESERVE ASSETS AND SHORT-TERM TREASURY BONDS
TO GROSS DEMAND DEPOSITS, ALL INSURED COMMERCIAL BANKS, JUNE 30, 1947

	Percentage of gross demand deposits						
	Treasury bills, certificates, and notes	Excess cash assets ^{a/}	Total special reserve assets	Deficiency or excess of special reserve assets if requirements are		Treasury bonds due or callable ^{b/}	
				25% of demand and 10% of time deposits	10% of demand and 4% of time deposits	Within 1 year	Within 1-5 years
<u>Nonmember insured commercial banks</u>							
Boston	19.2	1.2	20.3	-15.8	+ 5.9	5.6	41.5
New York	15.1	1.7	16.8	-16.2	+ 3.6	4.5	39.9
Philadelphia	20.9	.3	21.2	-11.1	+ 8.3	3.8	35.6
Cleveland	22.0	4.8	26.8	- 6.3	+13.5	4.6	37.6
Richmond	20.4	.2	20.6	- 9.2	+ 8.7	5.8	29.5
Atlanta	25.2	6.8	32.0	+ 3.8	+20.7	3.0	22.9
Chicago	29.0	5.9	34.9	+ 3.1	+22.2	4.6	39.8
St. Louis	25.0	4.7	29.7	+ 2.7	+18.9	2.2	22.5
Minneapolis	39.6	3.9	43.5	+12.8	+31.2	6.4	32.5
Kansas City	28.0	7.3	35.3	+ 8.6	+24.6	2.9	20.5
Dallas	16.5	10.4	27.0	+ .8	+16.5	.9	18.3
San Francisco	19.6	.6	20.1	-16.6	+ 5.5	7.7	39.3
Total	24.7	4.4	29.1	- 1.3	+16.9	4.2	31.0

a/ Total of (1) balances with Federal Reserve Banks, (2) excess of demand balances due from over demand deposits due to banks in United States, (3) coin and currency, and (4) cash items in process of collection, less (5) the sum of 20 per cent of demand deposits and 6 per cent of time deposits.

b/ These ratios are based on estimated holdings of such Treasury bonds.

TABLE 3

OWNERSHIP OF MARKETABLE U. S. GOVERNMENT SECURITIES
(In millions of dollars as of September 30, 1947)

Investor group	Total ^{1/}	Type of security			
		Bills certifi- cates and notes	Treasury bonds maturing or callable		
			Within 1 year	Within 1 to 5 years	After 5 years
Commercial banks	68,892	14,966	5,583	30,300	18,043
F. R. Banks	22,329	21,610	177	403	140
U. S. Government agencies and trust funds	4,387	81	50	362	^{2/} 3,858
Other investors	72,338	11,801	1,502	7,258	^{2/} 51,647
Total	167,946	48,458	7,312	38,323	75,688

Data estimated on the basis of the Treasury Survey of Ownership of Securities issued and guaranteed by the United States.

^{1/} Total includes postal savings and prewar bonds not shown in breakdown by issues.

^{2/} Most of the bonds due or callable after 5 years held by Government agencies and about 45 billion dollars of those held by other investors are not eligible for purchase by banks. About 7 billion dollars of these bonds may be acquired by banks.