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#### BRIEF REMARKS ON CERTAIN ASPECTS OF RESERVES

There has been a great deal of talk about excess reserves. Some of it has produced more heat than light. It seems important to me, therefore, to undertake to throw increased light on certain aspects of the subject which is so important to you, to the Federal Reserve System, and to the nation.

First: We have today the unprecedented amount of seven billion dollars in excess reserves. This excess can be used by the member banks of the System to extend credit by means of loans and investments.

Second: On the basis of this enormous volume of excess reserves the volume of deposits--now 60 billions--could be doubled. A volume of deposits twice as large could do twice as much work and if the amount of goods and services did not increase at the same rate, there would be the danger that prices would rise rapidly. This is not in the interest of a stable economy.

Third: It may also be pointed out that the same result could be achieved by doubling the use of existing deposits, namely, the sixty billions. In other words, at the present time the velocity of deposits--that is, the use or turnover of the present deposits--is about "thirteen". There have been times in the past when this velocity was "twenty-six". Therefore, if existing deposits should be used twice as actively as they are now used, that too would represent a dangerous situation. This is not in the interest of a stable economy.

Fourth: After deposits have once been created, there is little that the Federal Reserve System can do about them. That has to be dealt with by non-monetary means such as restricting of price advances, rationing, etc. The Federal Reserve authorities can, if given sufficient power, regulate the growth of deposits but they can not control the turnover of existing deposits.

Fifth: To control the growth of deposits, however, the Federal Reserve System needs sufficient powers in sufficient time to deal with the existing excess reserves should occasion arise for the System to act in the interest of a stable economy.

These facts are plain and simple. Let's now try to clarify the meaning of reserves.

I have found in talking about reserves that one often encounters misconceptions with regard to reserves and their functions. This is due principally to the fact that often the individual thinks of Federal Reserve Bank operations in terms of commercial bank operations.

An understanding of reserves requires more than that. It requires that the point of view of the banking system as a whole be taken; that the close inter-relation of bank with bank in an organic system be recognized as a fundamental condition and that the essential problems of central banking action be understood.

For example, there are those who sincerely believe that financing of Government deficits by banks increases excess reserves. This is not so, as I have attempted to show on previous occasions. When a bank buys a Government obligation and pays for it, the banker's reserves at the Federal Reserve Bank are thereby diminished and the Government's deposits at the Federal Reserve Banks are increased. On the other hand, when the Government later spends this money, the money goes into the hands of private persons in various sections of the country who pay their bills and the money finds its way into banks, or who themselves deposit the money in banks. The banks in turn re-deposit the money with the Federal Reserve Banks. The net result is that there has been no change in the total volume of member banks' reserves but there has actually been an increase in deposits. In other words purchasing Government securities by banks is lending to the Government by a bank and has the same effect on the volume of deposits as when a bank lends to anyone else. The extension of credit in either case increases deposits.

Incidentally, it may be mentioned again that Government deficit financing through the banks diminishes excess reserves. As deposits increase, required reserves, according to present percentages of reserve requirements, increase by roughly one seventh of the amount of the increase in deposits so that if the Government borrows a billion dollars from the banks, it will increase deposits by about one billion dollars and thus convert about one hundred and fifty million dollars of excess reserves into required reserves.

For the reasons outlined it has been suggested that a large part of future Government financing (though of course not all and certainly not at once) be accomplished, by drawing upon the existing large volume of deposits rather than by creating additional deposits through bank purchases of Government securities. This can be done by offering a security that will be desirable to and sought by the depositors, individuals, business corporations such as insurance companies and others. It has likewise been suggested that a means be provided for absorbing a large part of the existing excess reserves so as not to make possible a further large increase in deposits. The deposits are already large.

There is still another misconception. This misconception is even more widespread and has certain insidious implications.

Some think and say that when the Federal Reserve Banks engage in open market operations and are making discounts or advances to member banks the funds they use are the reserves of the member banks. What is worse, some even go so far as to say that the reason that the Federal Reserve System has raised or may in the future wish to raise reserve requirements is that it would have more funds to invest in Government securities. Of course this is not true.

It is perfectly apparent that an increase in reserve requirements does

not necessarily result in an increase of reserve balances. The result is a change in amount of reserves from one to the other of the two labels-- a larger amount on the books of the Federal Reserve Banks is labelled "required reserves" and a smaller amount on the books of the Federal Reserve Banks is labelled "excess reserves". The reserves, as such, at the Federal Reserve Banks may remain the same. The Federal Reserve System does not acquire any funds whatever by the process of increasing reserve requirements.

Furthermore the Federal Reserve Banks are not dependent on the member banks for their lending power. Let us look at our balance sheet. At the present time the Federal Reserve Banks have, on the resources side, twenty billion dollars of cash and two billion dollars of earning assets and on the liabilities side they have sixteen billion dollars of deposits and six billion dollars of Federal Reserve notes. If all the deposits of the Federal Reserve Banks were withdrawn by the member banks which, of course, could not happen, the result would be that the Federal Reserve Banks would have the same assets as before but instead of having sixteen billion dollars of deposits and six billion dollars of notes on the liability side of the statement, they would have no deposit liabilities but would have twenty-two billion dollars of note liability. There would be no change in the ratio of the Federal Reserve Banks' reserves to their liabilities which is about ninety per cent and there would be no substantial reduction in the Federal Reserve Banks' lending powers. I say substantial reduction--because as you know, the law requires the Federal Reserve Banks to hold a forty per cent reserve against notes--and only a thirty-five per cent reserve against deposits.

The lending power of the Federal Reserve Banks is based in the first instance on the power which Congress placed in the Federal Reserve Banks, when it established them, to issue Federal Reserve notes and to create deposits, holding forty per cent reserves against the notes and thirty-five per cent reserves against the deposits. Therefore, the lending power does not originate with the member banks; it originates from the Government granted power.

Since we have a practical situation in the Federal Reserve System and not a theoretical one, I shall not take your time now to discuss hypothetical and highly improbable situations, though I shall be pleased to have you send me questions or ask them tonight--after this dinner. Our actual situation is this:

The liabilities of the Federal Reserve Banks--notes and deposits--are used by the banks or the public continuously because they need them in their business operations.

Everyone needs a certain amount of pocket cash to meet certain kinds of expenditures. Therefore, Federal Reserve notes are issued. These notes stay out because they meet a public need and they stay out so long as this public need exists. When the public no longer needs them, they are returned to the banks and from the banks to the Federal Reserve Banks. If the need increases, the amount of notes increases and if the need decreases, the amount of notes decreases. This mechanism works well and we have no trouble with it.

As regards deposits, the member banks want their deposits to be in the Federal Reserve Banks and they want them there, not only because they are required by law to hold reserves in that form, but also because it is the most convenient way to clear with other banks and, finally, because the banks want to feel that a certain amount of their funds is absolutely intact and held in a public institution not operated for profit but devoted to the purpose of regulating the volume of bank credit in the interest of economic stability.

This is the case even in foreign countries where there are no legal reserve requirements. In those foreign countries, commercial banks maintain reserves with their central bank even though they are not required to do so under law.

To point this up, let me state that the power of the Federal Reserve Banks to invest in Government securities or to discount for or make advances to the member banks is based on the fact that Congress has given the Federal Reserve System certain powers and back of these powers lies the fact that modern economies have found central banking mechanisms an essential part of modern life. The Federal Reserve Banks' lending power, therefore, rests in the final analysis on the fact that they perform necessary central banking functions.

The Federal Reserve authority can therefore make additional reserves available when needed, quickly and in ample volume to meet all the credit demands that go with economic activity. This authority is in the discount powers, the powers of open market operations and the power to lower reserve requirements. They have ample power to increase excess reserves should conditions require an increase.

Finally, let me point out that not only do the Federal Reserve Banks not depend on member bank deposits for their lending power, but, quite the contrary, the Federal Reserve Banks under normal circumstances have the authority to regulate the lending power of member banks. When the Federal Reserve Banks lend to the member banks or buy securities in the open market, they create member bank reserves and, therefore, increase the member banks' lending powers. When Federal Reserve Banks are re-paid or when the Federal Reserve Banks sell Government securities, they diminish member banks' reserves and reduce the member banks' lending powers. It is, in fact, in this power to influence member bank reserves and consequently to influence their lending power that lies the principal instrument of credit control possessed by the Federal Reserve System and, therefore, since a large part of member bank reserves is created through Federal Reserve purchases of Government securities, it is absurd (isn't it) to say that the Federal Reserve Banks use the member banks' reserves. How can the Federal Reserve Banks be using member banks' reserves when the operation itself increases member banks' reserves? It would be a case where the creature is supposed to be the creator of its creator.

I hope I have been helpful in throwing some light on the subject of reserves.

We are all concerned with our national success. Our part--yours and mine--in national success is in the responsibility we have in connection

with influencing credit to the end of economic stability. It is plain common sense that to meet this responsibility, which is only one factor in the broad field of economic influences, the time to get ready to solve a national credit problem that may arise, is not when the problem is right on the doorstep of an individual bank--your bank for example--for then it may be too late.

Certainly too, everyone wishes to do his part in the program for national defense. That program has its effect on our national economy, now and later. You and I are in duty bound to be concerned with a strong national credit defense in the interest of economic stability in the United States. Economic stability makes for national success.