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Statement of

C. Canby Balderston

Vice Chairman, Board of Governors of the Federal Reserve System

before the

Senate Banking and Currency Committee

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STATEMENT BY VICE CHAIRMAN C. C. BALDERSTON
OF THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
BEFORE THE SENATE BANKING AND CURRENCY COMMITTEE

MARCH 23, 1959

Mr. Chairman and Members of the Committee:

The Board of Governors favors enactment of the proposal before your Committee, S. 1120 (or H.R. 5237), to amend section 19 of the Federal Reserve Act by making three changes in the present law respecting the reserve requirements of member banks.

This bill is not designed to make any radical changes in the existing system of reserve requirements that would have an important bearing on monetary policies. In the judgment of the Board, the basic characteristics of the existing system of reserve requirements provide a workable and effective medium for execution of monetary policy. The amendments proposed are for the purpose of removing from the present law some structural inequities and difficulties of administration. The amended law would provide a means of effecting gradually a better structure of reserve requirements within the existing framework, adaptable to meeting over the foreseeable future the prospective monetary and credit needs of a growing economy.

The bill proposes three changes in existing law that would authorize the Board to:

(1) Permit member banks to include in their required reserves all or part of their vault cash holdings in addition to balances with Federal Reserve Banks.

(2) Set the reserve requirements for demand deposits of central reserve city banks within a range

of 10 to 20 per cent, instead of the present authorized range of 13 to 26 per cent.

- (2) (3) Permit individual member banks in any part of a reserve or central reserve city to carry, where reasonable and appropriate in view of the character of business transacted by the individual banks concerned, reserves at the lower requirement level prescribed for country or for reserve city banks.

The relatively simple changes the bill would make in the text of Section 19 of the Federal Reserve Act are described precisely and completely in an attachment to this statement.

The purposes and possible effects of the proposed changes may be summarized briefly.

First, as to vault cash as reserves:

The counting of vault cash as reserves would correct a generally recognized inequity that now exists because many banks find it necessary for operating purposes to hold relatively larger amounts of vault cash than do other banks. Since vault cash holdings and reserve balances at the Reserve Banks are interchangeable and both have the same effect in limiting the volume of credit a bank may extend, it is logical and proper that both be counted as reserves. Doing so would also have collateral advantages: one would be to reduce the costs of transporting and handling currency; another would be to facilitate the holding by member banks of larger stocks of currency that would be available over widely dispersed areas for use in the event of a national emergency.

All member banks in recent years have generally held between

\$2 billion and \$2.5 billion in vault cash. Of the total, about three-fifths has been held by country banks, whose holdings constitute between 3 and 4 per cent of their net demand deposits. Vault cash holdings of reserve city banks as a group have amounted to between 1-1/2 and 2 per cent of demand deposits, while the ratio for central reserve city banks as a group has been less than 1 per cent.

The differences between these average ratios are in some degree compensated for by differences in the reserve requirement percentages for the respective classes of banks. Thus, while the amounts currently tied up by reserve requirements on demand deposits alone are 11 per cent for country banks, 16-1/2 for reserve city banks, and 18 for central reserve city banks, the percentage of net demand deposits tied up by these requirements and cash holdings--taken in combination--show much smaller margins of difference. As of February 1959, the combined ratio was 14.3 per cent for country banks on the average, 18.1 per cent for reserve city banks, and 18.6 per cent for central reserve city banks. In addition to these amounts, member banks have a reserve requirement of 5 per cent on time deposits at all classes of member banks.

Vault cash holdings, however, and therefore these combined ratios vary considerably among individual banks in the same class and also vary from time to time for any single bank. The greatest inequities in the present system of reserve requirements arise from these differences among banks in the same class as to their holdings of vault cash and not from differences between classes.

To add approximately \$2 billion to reserves at a single stroke by counting all vault cash as reserves without other action would, of course, not only add greatly to the total supply of reserves, and consequently to the lending potential of the banking system, but also would distort existing differentials in reserve requirements as between classes of banks. It would, therefore, be necessary to put any such change into effect gradually, and perhaps to offset it in part by adjustments in the reserve requirement percentages. Thus, when initiating the change, the Board could permit member banks to count as part of their required reserves either all of their vault cash or only a specified portion thereof.

Second, as to the percentage range for central reserve city banks:

Under present law, the Board has legal authority to alter differentials in requirements as between the broad classifications of member banks by reclassifying cities or by abolishing classifications, as well as by changing requirements.^{1/} By using this authority, any undue distinctions between classes of banks may be gradually reduced.

^{1/} Under the present law requirements may vary as follows:

	Minimum	Maximum	Present
Against net demand deposits			
Central reserve city banks	13	26	18
Reserve city banks	10	20	16-1/2
Country banks	7	14	11
Against time deposits - all banks	3	6	5

No change is recommended in the provision of the law that permits the Board to change reserve requirements within the permissible limits for the different classes of banks. These limits permit a doubling of requirements above the statutory minimum.

If vault cash holdings were counted as reserves, the effect would be to lower the required reserves of each class of banks. The reduction would be substantial for most country banks, which now have the lowest reserve requirements, and for some reserve city banks, but negligible for most central reserve city banks, which have the highest reserve requirements. Consequently, the Board is proposing that permissible requirements for central reserve city banks be lowered to the 10 to 20 per cent range authorized for reserve city banks. No changes are proposed in the permissible limits of the percentage requirements against net demand deposits as now stated in the law for reserve city and country banks--10 to 20 per cent and 7 to 14 per cent, respectively.

This amendment would retain three classes of banks in recognition of fundamental differences in the character of demand deposits held. The Board could retain higher requirements for central reserve city banks than for reserve city banks even though the amendment to the law would lower from 26 per cent to 20 per cent the maximum that could be required for any bank against demand deposits. In the judgment of the Board, a maximum of 20 per cent for any bank is believed to provide sufficient leeway for any increases that may be needed.

Third, relief for individual banks:

Under existing law, the Board is authorized to permit individual member banks in a central reserve or reserve city to carry the lower

reserves specified for banks in one of the other classes but only if they are located in the outlying districts of such cities. This provision now permits the Board to alleviate inequities which arise when banks located in such outlying districts are predominantly engaged in business that is similar to that of banks with a lower reserve classification. It does not, however, permit the Board to bring equivalent relief to such banks if they are located in the central or financial districts of reserve and central reserve cities.

The amendment proposed would permit more flexibility in exempting individual banks than is possible under existing law and thereby facilitate the elimination of some existing inequities. To accomplish these purposes the pending bill would strike out of the law the present relief provisos applicable only to "outlying district" banks, and add a new paragraph which would authorize the Board to permit member banks in any part of a reserve or central reserve city to carry reduced reserves. Instead of the geographical test, the Board would be authorized to grant permission for reduced reserves on such basis as it might deem reasonable and appropriate in view of the "character of business" transacted by the member bank involved.

As under present law, the amendment would make it possible for the Board to permit a member bank in a reserve city to carry the lower reserves specified at the time for country banks rather than that fixed for reserve city banks; and, similarly, a member bank in a central reserve city could be permitted to carry the lower reserves specified at the time either for reserve city banks or country banks. The amendment would not authorize the Board to permit any member bank in such cities

to carry reduced reserves equal to some percentage other than one prescribed by the Board for one of the designated classes of banks.

Again as under present law, the amendment would not authorize the Board to increase the percentages of reserves required to be maintained by individual member banks. The Board would, however, retain the authority which it now has under the law to designate new reserve cities or new central reserve cities and thereby increase the reserve requirements of all member banks in such cities, except such banks as may be specifically permitted to carry the lower requirements of another class.

The proposed amendment would make it possible for the Board to grant permission for reduced reserves upon the vote of a majority of a quorum, rather than only upon the affirmative vote of five members of the Board as required by the present law.

Other observations. - Before undertaking to answer whatever questions you may have, I should like to make, in conclusion, a few general observations.

The Board has given consideration to the careful and comprehensive study of the problem of reserve requirements and the proposals for changes made by the Economic Policy Commission of the American Bankers Association, and also to other plans for fundamental revisions in the reserve requirement structure. The Board has concluded, however, that far-reaching changes in the law are not necessary. With the amendments proposed, along with other provisions of existing law, the Board would have adequate authority to make any changes in the structure and level of reserve requirements that are likely to be appropriate under present or foreseeable conditions.

No change is recommended by the Board in permissible requirements against time deposits from the present range of 3 to 6 per cent. It is recognized that savings deposits in banks do not need to have as high requirements as demand deposits, which comprise the most active elements of the money supply, and the law correctly provides for differentials in such requirements. Unduly wide differentials between requirements against time and against demand deposits, however, encourage the shifting into time deposits of funds that are not true savings and are subject to withdrawal on short notice. Requirements against time deposits should not be so low as to encourage shifts of this nature. In the opinion of the Board, the present limits on requirements against time deposits are about as low as would be warranted for sound and effective operation of the banking system.

The principal function of reserve requirements, it is now generally recognized, is to serve as an instrument for regulating the ability of banks to expand credit and add to the available supply of money. Under existing law, Federal Reserve policies and actions may influence both the available supply of reserves and, within statutory limits, the amount of reserves required to be held.

The desirable ultimate level of reserve requirements need be no higher than essential for purposes of monetary policy. Yet they should not be so low as to raise questions about liquidity or safety in the asset structure of banks. Nor should they be so high as to hamper unduly the earning capacity of banks and their ability to perform essential functions. The precise level of requirements that may be appropriate for monetary

policy at any particular time in the future must be predicated on economic and financial developments at home and abroad.

Any changes in the general level of reserve requirements must be made only gradually and in relatively small steps in order to avoid undesirable disturbances to credit markets, conflicts with appropriate monetary policies, and undue upsets to long-established competitive relationships and banking practices. In order to provide for future contingencies, authority to vary requirements over a fairly wide range needs to be retained.

Legislative authority with respect to both the level and structure of reserve requirements for member banks should be sufficiently flexible to enable adjustments to be made in ways, in amounts, and at times that are consistent with the aims of monetary policy, with the international position of the country, and with the maintenance of a sound and effective banking system. Existing law with the amendments proposed would permit moving gradually toward a more equitable and rational structure of reserve requirements.

TEXTUAL CHANGES WHICH WOULD BE MADE IN SECTION 19 OF THE
FEDERAL RESERVE ACT BY S. 1120

[Omitted material stricken through; new material in capital letters]

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Every bank, banking association, or trust company which is or which becomes a member of any Federal reserve bank shall establish and maintain reserve balances with its Federal reserve banks as follows:

(a) If not in a reserve or central reserve city, as now or hereafter defined, it shall hold and maintain with the Federal reserve bank of its district an actual net balance equal to not less than seven per centum of the aggregate amount of its demand deposits and three per centum of its time deposits.

(b) If in a reserve city, as now or hereafter defined, it shall hold and maintain with the Federal reserve bank of its district an actual net balance equal to not less than ten per centum of the aggregate amount of its demand deposits and three per centum of its time deposits: ~~Provided, however, That if located in the outlying districts of a reserve city or in territory added to such a city by the extension of its corporate charter, it may, upon the affirmative vote of five members of the Board of Governors of the Federal Reserve System, hold and maintain the reserve balances specified in paragraph (a) hereof.~~

(c) If in a central reserve city, as now or hereafter defined, it shall hold and maintain with the Federal reserve bank of its district an actual net balance equal to not less than ~~thirteen~~ TEN per centum of the aggregate amount of its demand deposits and three per centum of its time deposits; ~~Provided, however, That if located in the outlying districts of a central reserve city or in territory added to such city by the extension of its corporate charter, it may, upon the affirmative vote of five members of the Board of Governors of the Federal Reserve System, hold and maintain the reserve balances specified in paragraphs (a) or (b) thereof.~~

NOTWITHSTANDING THE OTHER PROVISIONS OF THIS SECTION -

(1) THE BOARD OF GOVERNORS, UNDER SUCH REGULATIONS AS IT MAY PRESCRIBE, MAY PERMIT MEMBER BANKS TO COUNT ALL OR PART OF THEIR CURRENCY AND COIN AS RESERVES REQUIRED UNDER THIS SECTION; AND

(2) A MEMBER BANK IN A RESERVE CITY MAY HOLD AND MAINTAIN THE RESERVE BALANCES SPECIFIED IN PARAGRAPH (A) ABOVE AND A MEMBER BANK IN A CENTRAL RESERVE CITY MAY HOLD AND MAINTAIN THE RESERVE BALANCES SPECIFIED IN PARAGRAPHS (A) OR (B) ABOVE, IF PERMISSION FOR THE HOLDING AND MAINTAINING OF SUCH LOWER RESERVE BALANCES IS GRANTED BY THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, EITHER IN INDIVIDUAL CASES OR UNDER REGULATIONS OF THE BOARD, ON SUCH BASIS AS THE BOARD MAY DEEM REASONABLE AND APPROPRIATE IN VIEW OF THE CHARACTER OF BUSINESS TRANSACTED BY THE MEMBER BANK.

Notwithstanding the other provisions of this section, the Board of Governors of the Federal Reserve System, upon the affirmative vote of not less than four of its members, in order to prevent injurious credit expansion or contraction, may by regulation change the requirements as to reserves to be maintained against demand or time deposits or both (1) by member banks in central reserve cities or (2) by member banks in reserve cities or (3) by member banks not in reserve or central reserve cities or (4) by all member banks; but the amount of the reserves required to be maintained by any such member bank as a result of any such change shall not be less than the amount of the reserves required by law to be maintained by such bank ~~on the date of enactment of the Banking Act of 1935~~ nor more than twice such amount.

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